Challenges and Strategies for A-Share Investment

Speech Delivered by Herbert Zhang, CEO of China Universal Asset Management, at CUAM Investment Forum

Recently, Herbert Zhang, CEO of China Universal Asset Management ("CUAM", "China Universal") presented his views at CUAM Investment Forum on future market trends and the appeal for long-term investment in Chinese equity. Hebert also shared his thoughts on challenges and strategies faced by asset management companies in the future. Here is the script.

Dear guests:

Good morning! Welcome to CUAM Investment Forum. Today's topic discussion is all about strategy, macro and industry. However, I would like to return to the question of investment methods. At present, the asset management industry is in a period of great strategic opportunities. How to explore and seize opportunities in the future, and what challenges our investment philosophy, system and method will encounter are the topics that each of us practitioners needs to think deeply about. Today I'd like to avail myself of this opportunity to share my understandings.

I. Understanding of the future market trends

Actually, the general structure and direction of China's stock market is relatively easy to judge: though the stock index has a box volatility pattern, the market has significant structural opportunities. In fact, if there is a smart-beta index composed of high-quality stocks, it may witness a long-term bullish trend.

There are several reasons for being optimistic about the investment value of A-share high-quality assets. Firstly, the interest rate is declining in the medium and long term. Despite the overall adequate liquidity, there are actually few investment opportunities for certainty. Secondly, after being included in the MSCI EM index, Chinese A-share has become the most valuable investment sector in emerging markets. As a result it will be seen overseas investors increasing their allocation of China A. Thirdly, despite of the structural transformation pressure faced by Chinese economy, the Chinese market is still the largest consumer and service market in the world, with huge growth potential and a number of high-quality enterprises. To sum up, I believe that the long-term investment value of A-share will attract a large amount of long-term funds and active funds, which have huge investment demands for high-quality assets in the A-share market.

Why "structural opportunity"? ***The first reason is about the structure of China's stock index.*** The large-weighted stocks, which account for about 60% of the stock index, are related to China's traditional economy, while a large number of new-economy enterprises with high growth potential are not fully reflected in the index. As a result, the stock index cannot represent the accurate economic operation. ***The second reason is the "stratification" phenomenon in the A-share market***. I observe that China is now facing three stratifications, namely industry stratification, company stratification and entrepreneurship stratification. "Industry stratification" – though China's industry landscape has changed a lot, the proportion of representative growth industries is still relatively low. As I just mentioned, large proportions are taken by stocks related to traditional industries, which tend to be cyclical but lack of growth potential. "Company stratification" - severe polarizations exist between companies in the same industry, creating concentrated leading players and scale barriers. "Entrepreneurship stratification" - the past 40 years of reform and opening up have seen the emergence of many very entrepreneurial business leaders. Of course, there are also companies that profit from taking benefit from industry trend rather than relying on their own efforts, but these companies have gradually failed. ***The third reason is the change of the investor structure.*** According to the statistics, in 2003, about 70% of investors were actually the major shareholders of listed companies while the other 30% were retail investors, and the market had very low efficiency. Since then, the proportion of institutional investors has increased by one percent every year. Although up to now the proportion of institutional investors is still relatively low, the participation of institutional investors, especially overseas institutional investors, has reshaped the value investment concept of A-share, improved the market's ability to discover the value of high-quality stocks and will gradually increase its influence on the investment pattern in the future.

From these perspectives, the development direction of the entire market is quite clear. That's why our products have been launched along the strategic assets with various stable styles, as the core is to find out the best quality stocks to invest among assets with respective style characteristics. Recently, we've launched a mutual fund – CUAM Market Core Asset Growth Fund. The concept of "core assets" came out after the market has been through the last year. However, this is not a constant concept as the so-called "core" is actually changing. I have always believed that companies with good industry development trends and patterns, excellent corporate governance and outstanding entrepreneurship may all become core assets in the future.

In short, investment managers usually prefer to select market timing by looking at stock indexes, which in fact often covers up a lot of problems. Although the market may be in a box volatility pattern in a relatively long period, there are actually many structural opportunities and high-quality stocks with attractive smart-beta have great advantages.

II. The challenges we face and our responses

There are four contradictions in the current market. ***First, the contradiction between huge investable funds and a shortage of high-quality assets.*** When I talk to clients, I realized that even professional institutional investors always aim to acquire higher returns with lowest risk. However, in theory, the risks and returns are correlated. As we know, investors acquire higher returns by taking either the equity risk or credit risk. But due to the special nature of the source of funds in China market, few of large investors wants to take risks. Therefore, it is a challenge for asset managers to gain returns in the market and there's still long way to go in investors' education. ***Second, the contradiction between chasing short-term returns and ignoring risks.*** Investors always chase for hot products in the market due to their short-term returns but ignoring risks behind. Such products with unstable performance and unclear investment style may deliver attractive returns in the short run, but actually maintain huge risks from the long-term perspective, thus making it difficult for investors to make money. Historical experience shows that these "Short-term Phenomenal Products" have poor replicability and sustainability, and will eventually fade away. ***Third, the contradiction between the investment model with limited management capabilities and the growing investment demand.*** Today, the AUM of active equity managed by China Universal is around RMB 130 billion. According to the current management method, the investment capacity will be relatively limited.

Therefore if we are going to manage trillions of RMB assets in the future, what should we do to provide clients stable and high-quality asset? Thus I believe the whole industry will undergo great changes in terms of products and strategies. ***Fourth, the contradiction between the very short "psychological duration" of investors and the necessary time for investment returns to accumulate.*** We find that the Shanghai Composite Index has increased by 4% in the past 10 years, while the Value Selected Fund which is an active equity mutual fund launched by China Universal in earlier years has gained 350% within the same period. Why? I have repeatedly emphasized that the investment in Chinese stock is extremely profitable, but why don't investors make money? The main reason is that both the "psychological duration" and "assessment duration" are too short. Investment managers and management companies are always obsessed with making money in the short-term. But in reality, investment returns are usually seen in the long term, and the charm of stock investment also takes a long time to brew.

So what are the plans for China Universal to take in dealing with these challenges?

The first is to fully take advantage of our investment capabilities in active equity management, that is, capabilities of risk pricing, to radiate, migrate, and graft such advantages into fixed income and even passive investment. I just talked about the judgment of the market pattern. The long-term profitability of China's stock indexes, especially broad-based indexes, is far less than that of active investment. How to take advantages of China Universal's stock picking expertise to graft our fundamental research capability to passive investment, such as enhanced index or smart beta products, is what we are exploring now. In the field of fixed income investment, we've integrated our original industry research team and fixed income credit research team into one team with the purpose of further strengthening our credit analysis capabilities. Our long-term accumulation of active equity investment capabilities and unique cultural advantages in investment and research have ensured the smooth communication mechanism among various teams including equity, fixed income and indexes, making such transformation possible. This is our first plan.

The second is to create underlying assets with stable style, consistent performance and correct values, which are the "three targets" I consider very critical. Why we make these three targets?

First of all, regarding ***style stability***, products with stable style are actually very scarce in the market. Currently there are a large number of financial products with unclear risk-return characteristics in the market, which may look different on the surface but actually invest in the same type of assets. Take mutual funds for example. If we conduct analysis on the key industries invested by the top 50 mutual funds this year, we will find that these products are very similar, thus making investors very stressful to make efficient allocations due to the single source of return and the undispersed risk. Those who have experienced the extreme market in 2014 and 2015 will find that style stability is very important. The pension FOF fund which has been vigorously developed at the moment is facing such a dilemma of “style drift of underlying asset”. The principle of such target date FOF products is to achieve the investment effect of “reducing positions while people age” by means of a decline curve. However, due to the unclear risk-return characteristics of the underlying assets of FOF, the decline curve may be completely ineffective. For example, though the FOF position is relatively high, the beta of the stocks that the underlying fund invested may be relatively small; or vice versa, that the FOF position is low but the beta may be relatively large, making the decline curve completely unable to play the role of risk control. However, the understanding of “investment style” among the market participants is somewhat one-sided. For example, a lot of investors simply consider the CSI 500 related products as growth style while the CSI 300 related products value style, which may not be accurate in fact. According to textbook standards, growth and value style should be determined by the P/B and P/E characteristics, which requires the combination of top-down and bottom-up analysis in stock selection, to maintain a stable investment style through dedicated research. Therefore I require everyone in our research and investment team to make sophisticated products to fulfill investors’ demand on stable style assets.

And then let’s talk about the ***performance consistency***, which is the basic demand of investors but only a few funds could make it. Having been in the market for over a decade, we are used to see funds that led the market for a short period of time fell to the bottom when the market style changed, making investors feel like riding on a roller coaster and ended with making no money. One of the funds managed by China Universal has its AUM grown to RMB 13 billion this year, up from RMB 3 billion to 5 billion two years ago. The single year performance of this fund is actually just near the median level, but it maintained very stable performance even in the downward market of 2018, and its annual return in earlier years was also very consistent. Investors are becoming more and more rational, although the market trend is relatively stronger this year, with a lot of funds investing the trend, investors still recognized products with sustainable performance, which could be perfectly proved by the continuous growth of the fund AUM as mentioned.

Finally, about the ***correct values***, the core is to stick to our investment philosophy. China Universal seeks to deliver superior and sustainable investment return by selecting high-quality securities, seizing the trend of the market and constructing a portfolio with a medium to long-term perspective based on in-depth fundamental analysis. The essence of this investment philosophy is to make money by holding good stocks to share the long-term growth of enterprises. However, it is very difficult to do so as there are always various opportunities to make quick money in the short term and investors are easily to be impetuous facing such temptations. In addition, it's also a challenge to have a very deep understanding of the philosophy and making execution in practice. The so-called "good" stocks bought by the majority are actually names that performed well in the past, but few investors have the ability to judge clearly on what a really good stock is or whether the stock will have good quality in the future, as it requires profound understanding and insights of the company through long-term and continuous research and tracking, as well as a firm belief in our investment philosophy as mentioned. However, this year has been tough for those who adhere to this investment philosophy, as their funds suffered very slow growth in 1Q19 comparing to several soaring conceptual trends the market. But the truth is, what matters most will always be whether investors can make money eventually, especially gaining sustainable returns in the long-term.

Therefore, I require all my colleagues to put these "three targets" into practice. No matter what happens in the market, we shall always pursue ***stable style, consistent performance and correct values*** in our investment, and never drift with the flow.

The third plan is to establish clear underlying assets and build a multi-strategy product system. Separately, for active equity, the underlying assets need to be clearly classified by different styles and industries, as the "three targets" I mentioned before; in passive investment, we will graft our active investment capabilities to enhanced index and smart beta strategies. In fixed income investment, the hybrid products with a partial absolute return strategy are actually having great potential in the future wealth management market, which we have formed a comprehensive system for its investment and operation. Here I would like to add more comments on this kind of products. Many people in the market think that this kind of product is easy as it could make flexible adjustment due to its hybrid nature. But in essence, this kind of product only moderately exposes risks of equity positions to exchange for lower returns, and to achieve higher returns through timing selection. However, people always overestimate their ability to choose the right time, or they may ignore the Beta for a period of time, earn less revenue and eventually not perform well as expected. I have always believed that the most important source of return for this kind of product is actually the effective position rather than the absolute level of stock positions, as you may not run the investment portfolio effectively even with 100% position while may also achieve effectiveness with only 20% position, which in my opinion, all depends on your stock selection capabilities. We have been trying to explore effective management methods for this kind of products for a long time. In 2008, we launched a segregated account product for one of our banking clients investing through this strategy and gained positive returns, which mainly due to the positive returns contributed by our individual holdings. However, if we had frequently relied on low positions to make timing selection, I think the final results may not be very good.

I have just talked a lot about market strategies and solutions, which can generally be regarded as the “Tao” in the investment theory, but I’d rather consider them as my feelings and experience of the market. Finally, I’d like to share a short story. In a cold night, a Zen Master (a respected Buddhist monk) was sitting in meditation in the temple and asked his disciple to stir the furnace fire. The disciple saw there was no light in the furnace, and thought that the fire was out. Then the Master stirred the furnace by himself and saw flames shining in the ashes. “Plough deeply then sow abundantly. That’s how life works,” the Master said. There can be many ways to understand and extend this story. Back to the investment and the current market, I think that as long as you dig deeply into it, you will be able to gain – the so-called “fire in ashes”. I hope that everyone who comes to this Investment Forum can see the fire in ashes and acquire what you want. Thank you all.

Herbert Zhang

CEO of China Universal Asset Management

December 17, 2019