Adventures in China A Shares

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NEWSLETTER

Established in 1999 by its founder, Dr. Zhongjie Pu, Lepu Medical Technology, the "cardio king" of China, develops, manufactures, and markets high-tech, largely cardiovascular-related, medical devices and equipment. Up 74% in the past 12 months, Lepu's shares streaked past USD 10 billion in market capitalization by late May and the company's shares traded at an estimated 50x 2018 earnings. Although priced beyond the reach of a value investor today, we believe this company bears watching. Not satisfied with its dominant home market share in coronary stents (including bio absorbable stents and other cutting edge technology such as fully-automated pacemakers), Lepu is buying Chinese hospitals, hospital services, health insurance, and telemedicine companies. With all this expansion and innovation, the Lepu management team has robust revenue growth expectations for their company. During a recent meeting in its Beijing headquarters, we had a chance to ask questions about the company's operations. Importantly, Lepu – like so many Chinese companies – collaborates with the central government and excels at data collection. Lepu's newly-hired data scientists write machine learning software to analyze eleven years of the company's electrocardiogram (ECG) data. To supplement their incomes, doctors in 200 Chinese hospitals nationwide spend nights and weekends labeling ECGs to add to

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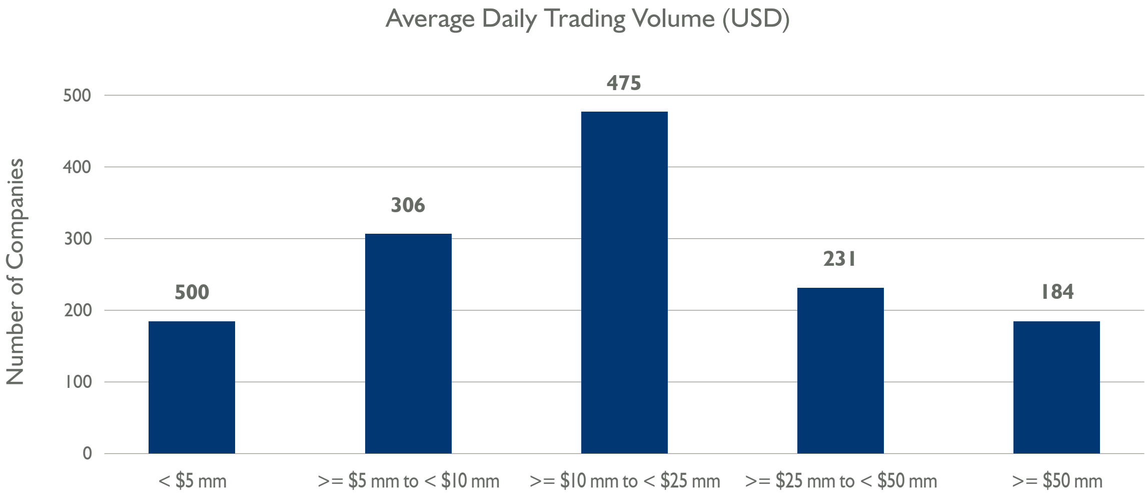
the data trove. Lepu expects the day will soon arrive when the combined knowledge of hundreds, and someday thousands, of doctors will be leveraged via artificial intelligence to diagnose a patient's heart condition. This should vastly improve the status quo, where patients suffer high error rates from the diagnosis of one or two cardiologists in busy Chinese hospitals. If successful, accurate software diagnostics should improve doctor productivity – possibly dramatically – and lower the cost of healthcare. As research analysts, we are skeptical that healthcare regulators outside of China would approve diagnostics based solely on Chinese data. Nonetheless, merely serving the domestic Chinese market could be a large growth opportunity.

Lepu strikes us as a good example of where private sector ambition, aided by the Chinese State, satisfies domestic investor appetite. Like most Class A share stocks with free float, Lepu's stock changes hands frequently: about eleven times the free float shares trade each day, on average. Reviewing companies listed on the Shanghai and Shenzhen exchanges, we found 184

A LIQUID MARKET: MANY CHINA A SHARE STOCKS HAVE EXHIBITED HIGH AVERAGE DAILY TRADING VOLUMES



Source: FactSet. Average Daily Trading Volume as of June 5, 2018, measured over the trailing 90 trading days.

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stocks with average daily trading volumes exceeding USD 50 million. Another 231 stocks had average daily volumes in excess of USD 25 million but less than USD 50 million. In contrast, only about 25 of the constituents in Hong Kong's Hang Seng Index trade, on average, more than USD 50 million per day.

While we do our research – interpreting reported financials, developing a relationship with senior management, and interviewing customers, suppliers and competitors – the Chinese investor isn't waiting around. They are diving right in. While private households in Singapore, South Korea and Taiwan favored life insurance policies and pension funds, Chinese investors have shifted their wealth largely into securities and similar products. Chinese retail investors have shown tremendous interest in recent years in China A shares; an estimated 51% of the A share market is held by retail investors according to data from Goldman Sachs. Retail investors in A shares have demonstrated a strong bias for technology and consumer stocks, despite the preponderance of financials and industrials in the Chinese market. The amount of wealth available for investment in China continues to expand rapidly. A recent report published by the Credit Suisse Research Institute revealed that total global wealth has soared to $280 trillion, and China represents $29 trillion of the total, an increase of $18 trillion over the ten years ending 12/31/17. China has the world's second largest equity market globally by market capitalization and by value of volumes traded, but foreigners only own just over 2% of A shares compared to approximately 30% of other Asian emerging markets. Despite its massive growth, China's A share market had zero representation in the MSCI All Country World Index (ACWI). China-domiciled companies traded on other exchanges (principally Hong Kong) represented 3.7% of the MSCI ACWI Index as of May 31, 2018.

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Facilitated by the Stock Connect program, this lack of representation is changing. Stock Connect, which allows international and Mainland Chinese investors to trade securities in each other's markets through the trading and clearing facilities of their home exchanges, is a collaboration between the Hong Kong, Shanghai and Shenzhen stock exchanges. Effective June 1, 2018, MSCI started phasing in the China A share market using a 2.5% inclusion factor to add 234 large cap A share stocks, out of more than 3,500 potential candidates, to the MSCI Emerging Markets (EM) Index. This first wave includes large cap stocks with sufficient free float accessible through the Stock Connect program, and which have incurred limited past trading suspensions. Stock Connect includes many more stocks than MSCI has targeted for the EM Index, and limits the trading volumes in a quota system. Over the next few years, those quotas should rise.

The EM Index inclusion factor rises to 5% of the A share market on September 3, 2018. Eventually, A shares could account for 9-10% of the EM Index after 50% of A shares are included, and 17% after full inclusion. Complete 100% inclusion of A shares could swell China's EM Index weight to over 45%; however, this would require China to end its stock trading quota system, enact full liberalization of capital mobility restrictions, and align internal accessibility standards. This seems unlikely in the next 10 years. To invest in stocks listed on the Shanghai and Shenzhen stock exchanges, we must understand the many risks, including stock-specific, corporate governance, and political and regulatory constraints. As for any diversification benefit gained by adding China A shares to an equity portfolio, we believe the low historical correlation China A shares have enjoyed with other equity markets will change if the A share market matures, opens more to foreign investors, and

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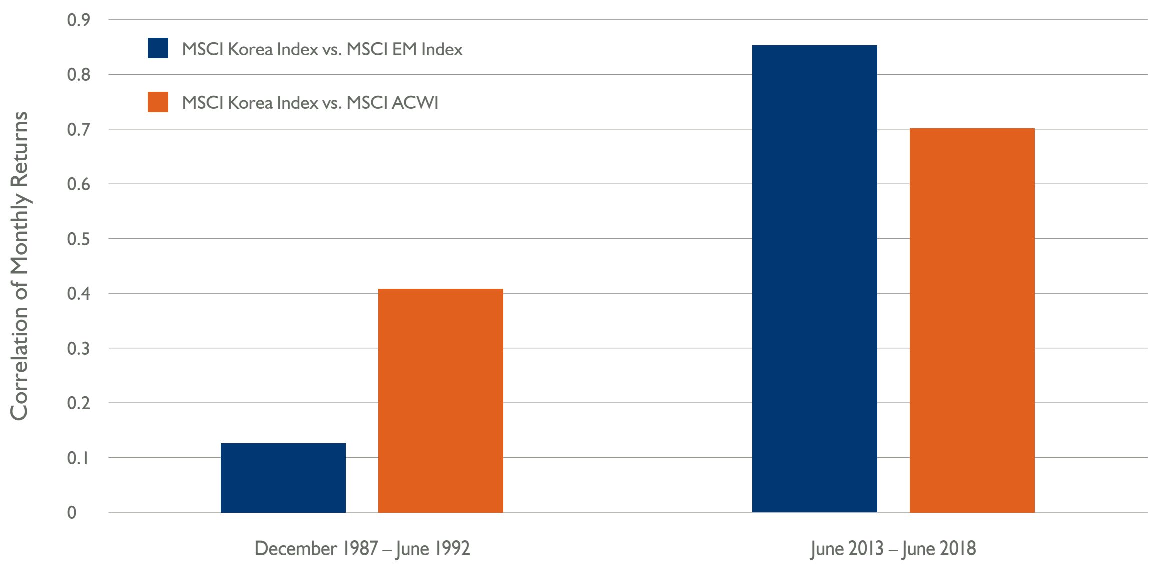
incurs less intervention. We believe Chinese A share market correlations will rise relative to other global stock markets, especially since there are many Shanghai stocks that also trade in Hong Kong. However, full inclusion of China A will take many years, so diversification benefits will diminish gradually.

For historical perspective, we can compare China A shares to South Korea and Taiwan inclusions into the emerging markets indices. From start to full emerging markets index inclusion, South Korean investors had to wait for six years ('92-'98) and Taiwan for five years ('96-'01). As the South Korean equity market became more accessible to foreign investors, correlations with global markets increased. The MSCI Korea Index correlation with the EM Index and ACWI increased dramatically from the 1987-1992 period to the 2013-2018 period.

But there are important differences which suggest China A share correlations with global markets may rise slower than Korean

DIVERSIFICATION BENEFITS FROM S. KOREAN STOCKS HAVE DIMINISHED



Source: Bloomberg

stocks. First, neither South Korea nor Taiwan had a closed capital account. China is attempting to circumvent this situation with Stock Connect (and the participating exchanges keep raising the volume limits), but this will progress slowly. Second, China A share companies can stop their stock from trading for long periods of time with virtually no explanation in an effort to ensure market stability. These oddities of the A share market reduce correlation. Lastly, we must recognize the interests of the Chinese State. To the extent that China state-owned enterprises continue to be buyers of last resort, correlations may remain lower than they would be in the absence of such interventions. Market risk factors in China A shares tend to reverse quickly relative to other markets due in part to such interference.

The vast size of the China A share market and the many dynamic constituent companies demands research attention. Regardless of the level of scrutiny, we know to expect the unexpected in China A. With time, market transparency should improve. For now, however, let the adventure begin.

Important Disclosures

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International investing may involve risk of capital loss from unfavorable fluctuations in currency values, from differences in generally accepted accounting principles, or from economic or political instability in other nations.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index, designed to measure equity market performance of emerging markets, consisting of 24 emerging country indices. The MSCI ACWI Index is a free float-adjusted market capitalization weighted index, designed to measure the equity market performance of developed and emerging markets. The MSCI Korea Index is a free float-adjusted market capitalization index, designed to measure equity market performance of the South Korean market. It is not possible to invest directly in an index.

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