


Gemologist

The China question



By Gary Greenberg, CFA
Head of Hermes Emerging Markets
and Lead Portfolio Manager

Key points

Investors who enjoyed the rally in China stocks before the recent volatility now face the question: sell or stay the course?

China bears argue that the market is overvalued and the nation's economic model is fragile. We disagree

Top-down risks warrant concern, but we have spent enough time on the ground to understand the strong bottom-up fundamentals of the Chinese stocks we invest in

Despite its intervention to halt the market slide, we believe the government is more likely to progress with its economic reforms than regress

The Chinese equity market has been swinging violently in recent weeks, and investors like us who have enjoyed the preceding rally are now faced with the choice of holding on to good stocks that they believe remain undervalued, or heading for the hills! We started the year with a 14.4% overweight in China and began reducing the non-benchmark A-share portion of this in early June as valuations continued to climb. We cut our exposure by scaling back positions rather than exiting them completely, as we still believe in the fundamentals of the stocks we own, and entered the turbulence of July with a much smaller overweight¹. Here we intend to take you through our thought process, which has led us to remain invested.

Mainland China stock markets are immature and almost exclusively the province of retail investors, few of whom apply fundamental security analysis. Therefore, in the past, few professional investors in the West ventured into the mainland 'casinos' because they seemed to hold little value. But in 2012, with the Shanghai Composite Index having corrected from a multiple of about 48x in 2007 to about 12x, we decided to take a closer look. What we found was that Chinese retail investors liked 'story stocks' and were willing to pay what we considered to be unreasonably high multiples for them, but were deeply uninterested in the blue chips. They were right to ignore most of these, as they are primarily state-owned enterprises (SOEs) with low levels of profitability and worsening balance sheets, carrying out a perceived national service by employing tens or even hundreds of thousands of workers, and with little regard for shareholder value. Yet not all of them were chronically inefficient, and so myself and the Asia analysts in my team travelled extensively around mainland China to get to know some of the more promising ones. We identified a number of well managed, modestly valued businesses that stood up to our analysis and became holdings in the portfolio.

Amid the current volatility, remaining invested in China – or establishing new positions as opportunities arise – runs the risk of getting caught in the long-term bear market that some say will be the inevitable aftermath of government support that has long distorted price discovery. But even in a market which is overvalued – and this point, we believe, is arguable – there are individual companies with good long-term growth prospects that remain undervalued. The dispersion of valuations between the Hang Seng China Enterprises Index (Hong Kong-listed mainland companies, mainly state-owned), the ChiNext (small-cap, early stage, fast-growth companies), the Shenzhen Stock Exchange (more mature, but mainly 'new economy' stocks) and the Shanghai Stock Exchange Composite Index (a combination of SOEs and private companies) is enormous, from 15x to 70x. In addition, the sheer size of the Shanghai market, with more than 1100 companies, along with the Shenzhen bourse and its 1,700 names, gives plenty of scope for stock picking. It is hardly surprising that there are reasonably valued opportunities within such broad indices, whose components are clearly not homogenous. Such stock-picking opportunities, and the likelihood that Chinese economic reform will continue throughout this turbulence, means that investors should be wary of, not deterred by, the volatility of July.

We were bullish on China all last year and through May of this year, but became cautious as the rally progressed, and cut our exposure closer to neutral late in the second quarter. Little had come from the promising reforms outlined in the Third Party Plenum in late 2013 besides the so-called anti-corruption measures that were reminiscent of the purges of Stalin and Mao.

The economy continued to grow but only due to increasing levels of debt, and the government's plan to recapitalise the banks and SOEs – by issuing shares to foreigners who would be driven into the A share market after its inclusion in the MSCI Emerging Markets Index – seemed to have stalled. The robustness of the vendor-financing scheme called One Belt One Road, intended to create new outlets for China's old industries like steel and aluminium to countries across Eurasia, the Middle East, Africa and south-east Asia, had come under question.

China's targeted transition to a market economy is still possible, but with every passing quarter this becomes more difficult to achieve as debt levels and industrial overcapacity increase. It is concerning that the recent volatility in Chinese equities, which provided an early test of the government's resolve to liberalise markets, spurred an official intervention preventing the market from determining reasonable valuations. Such action, though understandable and not unprecedented, looks misguided and casts doubt on China's ability to embed reforms. From a top-down view, therefore, China looks very risky. And yet, from a bottom-up perspective, we are finding compelling stocks to own. And not all of the top-down conditions are bad. Financial deregulation, to name one important reform, continues apace, with important reforms to local government financing and the market is being allowed to play a greater role in setting both lending and (very recently) deposit rates. China's new exchange-rate policy, in which the value of the renminbi will be fixed each day based on the previous closing spot rate, is a significant step towards liberalising the currency. It is a necessary move, too, as a rigid dollar peg is not a long-term solution for the world's second-largest economy.

From a top-down view, China looks very risky. And yet, from a bottom-up perspective, we are finding compelling stocks to own

Japanese whispers

Some investors have been in the market long enough to remember how difficult it was to find good, attractively valued stocks in Japan during the late 1980s bubble and in subsequent years. Early in my career, I was tasked with picking offshore stocks for a small- and mid-cap US mutual fund that was going global. At the time, Japan represented more than 60% of the MSCI Europe Australasia Far East Index, and so everyone felt that some exposure to Japan was essential. This was the period when Japan seemed to possess a special magic, manufacturing products more efficiently than the West and creating value purely from 'zaitech',

¹ This was 5.8%, but our actual exposure to the Chinese economy was far less. Adjusting for our holdings in Techtronic Industries and Samsonite, which manufacture in China but sell products mainly in developed markets, our China exposure amounts to a 1.38% underweight. Source: Hermes as at 18 August 2015.

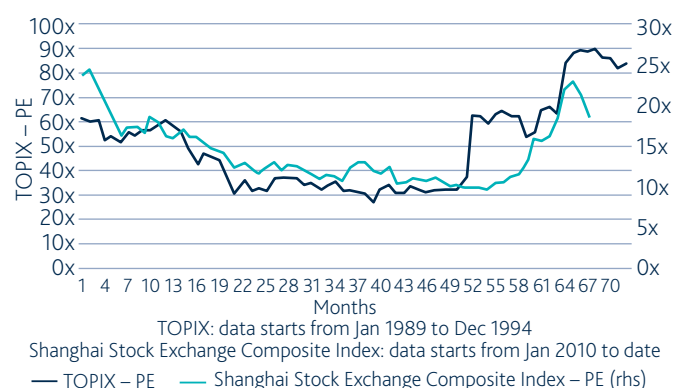
an early form of financial 'innovation'. Price-to-earnings (PE) ratios skyrocketed, capital became nearly free and real estate values went to the moon. The Japanese 'miracle' was in full swing, until it wasn't, and the bubble deflated, ushering in decades of economic stagnation.

Even in a market which is overvalued – and this point, we believe, is arguable – there are individual companies with good long-term growth prospects yet remain undervalued

The strong economic performance of Japan's neighbour, China, in subsequent decades created a similar halo around the nation's economy, and thus captured investors' attention – especially as the mainland market took off in late 2014. Yet it would be overly facile to equate the recent Chinese rally with the Japanese bubble, for the simple reason that there was scarce value apparent in boom-time Japan, whereas opportunities to buy good stocks at reasonable valuations exist in China today. In the Japanese bull market it was highly unusual to find a stock trading under 20x earnings, a return on equity of over 20%, or sustainable growth of more than 15%. But lots of cheap stocks are currently available in China, and the Shanghai Stock Exchange trades at about 15x 2015 estimates, which, given that we are in August, is probably a reasonable estimate of what will be the eventual outcome.

Sceptics love to adjust this rather modest multiple, which contradicts the bubble classification they have cannily identified, by extracting bank shares, which trade at mid-single-digit PE ratios, offer generous dividend yields and have a significant weight in the index. But banks are generally among the cheapest sectors in any market, and Chinese banks, priced at no more than book value with more than 200% coverage of non-performing-loan books (which are, granted, almost certainly understated), might prove to be less terrifically overvalued than the bears think.

Figure 1. Turning Japanese? Trailing PE multiples of Japan and China during their respective bull markets



Source: Bloomberg, Morgan Stanley Research, Hermes

Looking at these valuations, we don't believe that the Shanghai Stock Exchange is necessarily in bubble territory. Neither are Hong Kong-listed H shares: the Hang Seng China Enterprises Index trades at about 8x 2015 estimates, though it generally hosts lower quality ex-growth companies. Yes, the ChiNext index of small-cap technology stocks trades at about a 100x trailing PE and about 70x on 2015 estimates, and the Shenzhen Composite Index trades at about 30x 2015 estimates, but we have still found attractive companies in Shenzhen trading at quite reasonable valuations.

Opportunities in China

Such companies that we have identified over the past three years exist across the spectrum of China's economic development, from industrialisation to manufacturing to consumption. Current holdings include a manufacturer of air-conditioning goods and a provider of CCTV and surveillance systems, which are both Shenzhen-listed. These companies benefit from economic moats and expanding customer bases, and are more efficient and sustainable than peers. The multiples of these stocks are nothing like the crazy ones we encountered during Japan's heyday, and their profitability is healthy, removing any temptation to adopt technical analysis or 'relative cheapness' to justify positions. Fundamentally profitable companies with good balance sheets and competent management teams, at reasonable prices, should prove to be good long-term investments, even if the Chinese economy slows. And some of our companies are manufacturers that sell products overseas, providing some insulation from domestic events.

China sceptics will continue to say that the country's growth is one big fabrication, in which the vast majority of companies invent their sales and earnings figures, and that what appears to be value is just a mirage. But for those of us who have been investing in China for decades, we have heard such carping from day one and have subsequently disregarded it after observing first-hand how people's lives changed: how rice paddies became factories and office blocks as part of the truly staggering development that has taken place. Wherever the current economic model takes China, and no matter how difficult its transition to a sustainable economy turns out to be, believing the naysayers over the last 25 years would have you expect, when you get off the plane in Shanghai, to see giant statues of Chairman Mao presiding over agricultural fields and austere concrete buildings, something like one imagines in North Korea, and this is obviously not the case. There is real development in China: real energy, enterprise and effort in education and innovation.

Pivotal decisions that will shape the investment environment in China – and the country's future – are being made right now

We are not minimising the challenges facing the nation's economy, or whitewashing the heavy-handed market interventions that the authorities have orchestrated in recent weeks. As mentioned earlier, we cut our overweight in June, avoiding the worst of the downdraft. We will wait until the government steps back, and the market again becomes the primary arbiter of valuations, before increasing existing holdings or building new positions. As long-term investors, we continue to focus on China's economic reform process, which will determine the

destiny of the country over the next several decades. In fact, pivotal decisions that will shape the investment environment in China – and the country's future – are being made right now.

The conclave gathers

As investors, we make informed predictions about what could transpire in China in the next five years. The nation's chief policymakers, however, determine its path. Amid the tension between state intervention and market liberalisation, what is arguably the most important political meeting since the Third Plenum is currently underway. Moved forward from its annual slot in late August, the apparently informal summit in the beach resort of Beidaihe, east of Beijing, involves nearly every senior Chinese Communist Party member and typically results in policy decisions that are later formalised in the capital.

China's current five-year plan, which expires this year, focused on economic reform for sustainable growth, industrial advancement and greater domestic consumption. These are no longer abstract concepts for the nation, and the decisions made in Beidaihe will underpin the next five-year plan as the world's second-largest national economy makes critical development choices. There are concerns that the recent turbulence may slow the progress of market-based reforms, but these might not recognise the fact that President Xi Jinping is a chief proponent of the changes. Given the steps already taken, failure to push ahead would be impractical and signal weakness at the top. Such a retreat could also be seen by the public as a return to the 'old China' and the market manipulation, political positioning and cronyism that was rife in the past.

The market decline has slowed the reformist march, probably temporarily, and given weight to the doubts over China's ability to achieve sustainable growth. The top-down view is worrying, but the economic and political conditions are still fertile enough for efficient, quality companies with astute management to perform strongly, and they are valued more cheaply than many people think. Our answer to the China question is this: like the sceptics, we are cognisant of and concerned by the macroeconomic and political risks; however, these fears are allayed by the quality of certain companies that we, unlike the sceptics, know well. Now, if only the government would let the market determine valuations.

The decisions made in Beidaihe will underpin the next five-year plan as the world's second-largest national economy makes critical development choices

With senior Party officials sequestered in Beidaihe, newsflow will be limited at least until the meeting concludes. In addition to the semi-pegging of the renminbi to the dollar, there is evidence, however, of a continuation of reform even as the government distorts the stock market. By the end of July, 33 provinces and cities had issued at least one tranche of formal local government debt worth \$230.4bn. This is part of the government's debt-swap programme, under which higher-interest-bearing debt, which has been taken on by local governments to fund a glut of investment projects, is exchanged for low-cost bonds. The government has confirmed that a further \$161.1bn has been approved and allocated to local authorities. The state continues to loosen its grip on SOEs by mandating large increases in the extent of securitisation and mixed ownership of such companies in Shanghai, Shenzhen and Guangzhou. An unconfirmed but highly plausible report in the South China Morning Post suggests that a top-down blueprint has been approved, with two new Temasek-like companies that will channel funds to SOEs and pressure them to turn a profit². At the consumer level, import tariffs on selected apparel, cosmetics and baby products have been cut by 50% to boost retail consumption and foster competition.

² "How China's Singapore-like plan will 'boost growth' by shaking up state-run behemoths," by Keira Lu Huang, published in the South China Morning Post on 8 August 2015.

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