GAM Multistock - China Evolution Equity

Marketing material for professional / institutional / accredited investors

Market environment

The MSCI China Index (USD net return) fell 1.9% in the third quarter, as investor sentiment remained cautious amid soft momentum of Chinese economic recovery and concerns over the real estate slowdown. Despite good earnings results, stock prices drifted lower in the quarter. Investors await catalysts from further positive government policies to support the real estate market and the economic recovery.

Among sectors, energy, consumer discretionary and healthcare outperformed the most. Utilities, information technology, industrials and real estate lagged the most.

Performance

GAM China Evolution Equity declined 2.0% (USD C-shares) in the quarter. The fund's performance was driven by the following factors.

- Sector allocation had a slightly positive impact in the quarter. The overweight in consumer discretionary and the underweight in consumer staples and utilities had a positive impact. However, the underweight in energy and the overweight in communication services detracted from the performance.
- Stock selection had a positive impact in consumer discretionary but a negative impact in healthcare, communication services and information technology.

Since the fund's inception on 2 December 2013, the fund's USD C-shares have registered a return of 60.3%, versus the 9.1% return of the MSCI China Index during the same period.

Performance contributors

- New Oriental Education rallied in the quarter on continuing recovery in sales and earnings growth following the company's repositioning away from after-school tutoring.
- Retail company Miniso Group rose nicely in the quarter as the company delivered solid earnings results with record high profit margin.
- E-commerce company PDD Holdings outperformed in the quarter on better-than-expected revenues and earnings.

Performance detractors

- Smart home appliance manufacturing company Ecovacs Robotics declined in the quarter on slowing demand.
- 37 Interactive Entertainment fell in the quarter following the previous rally.
- Leading e-commerce player JD.com underperformed on concerns over intensifying competition.

Positioning

The fund's strategy remains focused on industries that benefit disproportionately from China's evolution towards a consumer and innovation-driven economy.

Sector exposure

Consistent with the fund's investment focus and based on the bottom-up opportunities we find, the fund has large exposures to consumer discretionary, communication services and financials. In the quarter, we reduced exposure to financials, industrials and communication services and increased exposure to consumer discretionary and information technology.

Listing types and currency exposure

The portfolio has circa 40 stocks diversified across listing types. We currently favour Hong Kong-listed Chinese stocks over A-shares, as A-shares trade at circa 40% premium over Hong Kong stocks. The fund invests circa 16% in Chinese A-shares, 12% in US-listed Chinese American Depositary Receipts (ADRs) quoted in the US dollar, with the remainder invested in Hong Kong-listed Chinese shares (H-shares).

Jian Shi Cortesi
Manager of GAM China Evolution Equity

GAM Investments

Outlook

Looking at the MSCI China Index historically, the index is currently trading at the very low end. It is currently more than 50% below the previous peak. The MSCI China Index has delivered little performance for 10 years despite the fact that both the economy and corporate earnings have grown significantly over the decade. Yet stock prices have not risen in line due to valuations contracting. We find many companies trading at the lowest valuations we have seen in more than a decade.

Weak confidence has been holding China equity back. The confidence over China equity is the lowest we have observed since the Asian financial crisis in 1998. Confidence is weak due to the softening economic growth momentum, real estate drag and the US-China tensions. In addition, policy stimulus has been below expectation, as the government is trying to balance the need to support the economy in the short-term while not creating problems for the long-term, in our view. Finally, every time sentiment is already low on China, investors raise the structural headwinds such as ageing populations. Looking at these factors, investors have not been in a hurry to allocate to China equity.

When looking at the MSCI China Index's performance relative to the MSCI World, China has underperformed dramatically since 2021. Behind that underperformance was the contraction of valuations. The price of sales of the MSCI China relative to MSCI World was about 1.1x a decade ago. Today that ratio is approximately 0.5x, showing how much China has derated. The price-to-book ratio of MSCI China is also close to the historic lows. Underlying these low valuations are the investor concerns previously referenced.

Given the counter-cyclical nature of Chinese policy, we believe the Chinese government will roll out further supportive policies for property and to support growth recovery. This would be necessary to help China break out of the confidence trap. We have already seen a number of supportive measures. There has been a mortgage rate reduction and the relaxation of home purchase restrictions. Chinese home owners remain in good financial health, with mortgage delinquency rate at 1.2% in 2022. We believe speeding up the bankruptcy process and asset liquidation process of the troubled developers will help the real estate market return to a healthy state.

In our view, the more certain driver for stock prices would be earnings growth. Looking at earnings growth projections, the fastest earnings growth this year would come from service sectors, not surprisingly after the post-Covid reopening. The overall EPS growth estimate is in mid-teens. We continue to see many of our portfolio companies deliver good earnings results. While some of these results were ignored by the market and not yet reflected in the stock prices, we have seen some stocks started responding positively to improvements in earnings, such as education companies. In the short-term, stock prices are driven by perceptions. In the long-term, earnings growth drives stock prices. It is a matter of time before investors notice the earnings improvement, in our view.

In terms of investment opportunities, we see opportunities in:

- The technology cycle is showing signs of bottoming out in China. AI is coming as a timely catalyst. Our portfolio has exposures geared to AI-related names, such as Chinese internet names with AI exposure.
- The China re-opening theme, including travel platforms, sportswear, restaurants.
- Clean energy: In the last 12 months we have seen much stock price correction in clean energy related names, which could provide attractive entry points.

Important legal information

Credit Risk / Structured Products: Should the counterparty to a structured note default, the value of those structured notes may be nil.

Currency Risk: The value of investments in assets that are denominated in currencies other than the base currency will be affected by changes in the relevant exchange rates which may cause a decline.

Liquidity Risk: Some investments can be difficult to sell quickly which may affect the value of the Fund and, in extreme market conditions, its ability to meet redemption requests.

Currency Risk: Non Base Currency Share Class: Non-base currency share classes may or may not be hedged to the base currency of the Fund. Changes in exchange rates will have an impact on the value of shares in the Fund which are not denominated in the base currency. Where hedging strategies are employed, they may not be fully effective.

Market Risk / Emerging Markets: Emerging markets will generally be subject to greater political, market, counterparty and operational risks.

Single Country Risk: Investment in companies of a single country may be subject to greater political, social, economic and tax risks and may be more volatile than investments in more broadly diversified funds. Local tax law may change retrospectively and without notice.

Special Country Risk / China: Changes in China's political, social or economic policies may significantly affect the value of the Fund's investments. China's tax law is also applied under policies that may change without notice and with retrospective effect.

Equity: Investments in equities (directly or indirectly via derivatives) may be subject to significant fluctuations in value.

Onshore Renminbi Currency Risk: Currency control decisions made by the Chinese government could affect the value of the Fund's investments and could cause the fund to defer or suspend redemptions of its shares.

Shanghai-Hong Kong Stock Connect / Shenzhen Connect Risk: The Fund may be investing in China A Shares via the Shanghai – Hong Kong Stock Connect / Shenzhen Connect which may entail additional clearing and settlement, regulatory, operational and counterparty risks.

Capital at risk: All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed.

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