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After doubling in prices since late October, are Chinese equities still looking attractive? Is it too risky for investors to enter these red-hot stocks at current lofty levels?



COVER STORY



China's reality check

After doubling in prices since late October, are Chinese equities still looking attractive? Is it too risky for investors to enter these red-hot stocks at current lofty levels?

BY KELVIN TAN

A Chinese herbal shampoo maker goes for a listing and all of Hong Kong comes to a standstill. **Bawang International**, which sought to raise \$309.6 million through an H-share IPO in Hong Kong last month, soaked in \$13.5 billion cash. A small local Hong Kong brokerage received several hundred million dollars' worth of orders from retail investors in the first few minutes of the IPO's opening.

Just about everyone wanted to get a drop of the shampoo maker, a supposed beneficiary of China's rising personal consumption. The queues outside brokerages in Shanghai, Shenzhen and even Hong Kong haven't been this long in years. Individual investors in China opened 700,617 new stock trading accounts last week — the highest weekly figure since January 2008. Shanghai's benchmark index is up nearly 88% this year — making it the world's best-performing market. "It's a classic top," says Hugh Young, managing director of Aberdeen Asset Management Asia in Singapore, one of Asia's best-known value investors.

Fund managers like Young watch for tell-tale signs of market bubbles and troughs. The way he sees it, the signs have been there for some weeks now. "It's a sharp liquidity-fuelled rally," Young tells *Personal Wealth*. "The easy money is over. Investors should be darned cautious of what is going on because it is out of sync with the underlying reality and more a reflection of government stimulation." But that doesn't mean Young, whose Aberdeen China Opportunities Fund is up 56% year-to-date, is selling aggressively or taking profits. Indeed, Aberdeen's exposure to mainland stocks has been small, to start with. Still, as the Asian investing world's voice of reason, Young's comments on the mania in Chinese stocks are res-

onating through the region.

Having bottomed late last year, China stocks have been on a tear, spurred by the Chinese government's RMB4 trillion (\$640.7 billion) stimulus package, which has kick-started economic growth and led to a huge surge in bank lending and higher asset prices for the world's most populous nation. With whopping gains of more than 100% and 150% for the Shanghai Stock Exchange Composite Index (HSCEI) and Hang Seng China Enterprises Index (HSCEI) respectively since their October lows, the stellar performance of Chinese stocks has surprised even bulls like Chua Soon Hock, who runs a hedge fund with assets of about \$1 billion at Asia Genesis Asset Management and is becoming increasingly uncomfortable investing in China shares.

On July 29, the SSEC lost as much as 7.7% of its value before ending the day down 5% on record-breaking daily trading volume of \$62.35 billion. (The average daily turnover in Singapore is more like \$2 billion these days, give or take a few hundred million.) Last week, China stocks kept their gradual slide on the slippery slope. By Friday, the downward momentum had turned into a frenzy of selling in most of the Asian markets.

What's happening? China's rally is starting to creep out even the more savvy investor and old bull. Chinese stocks are in "bubble land" because they are supported by excessive monetary liquidity and aggressive bank lending, declares Chua, whose macro hedge fund is up 22% this year as at end-June. "The H-Share Index, at 12,000, has just exceeded my most bullish expectation," he adds. Louisa Lo, head of Asia ex-Japan equity at fund house Schroders, couldn't agree more. "Given the magnitude of the rally [in Greater China equities], we have trimmed our overweight position and are

looking to lock in gains on further strength," Lo says. Although the Chinese economy is showing clear signs of stabilisation, she points out that Chinese stocks "have more than factored in" such spectacular economic recovery. "Valuations, particularly for cyclical, are no longer attractive after the recent sharp rally, while the earnings outlook is likely to remain difficult this year," she adds.

Still, Chua says investors "must respect the herd force of bubbles", as stock-market bubbles generally tend to last longer than most people anticipate. "The bubble can burst anytime when the Chinese government changes policies, but it can also balloon much bigger if misguided policies remain in place," he adds.

Many fund managers and strategists say it is still too early to obsessively worry about any speculative equity bubbles building up in China, given that the global equity rally is still in place. "Some pundits are already talking about a bubble [in Chinese stocks]," says Wong Kok Hoi, founder and chief investment officer of local boutique fund-management house APS Asset Management. "I am not sure that is indeed the case because [China's] stimulus plan is working well." Wong, a veteran fund manager with more than 25 years' experience, argues that China's economic growth is being powered by robust consumption and investments. "GDP will grow 8% to 9% this year, with fixed asset investment contributing 5% to 6%", he says, adding that consumption will add 5% to economic growth to compensate for the -2% to -3% slump in net exports. "Against this backdrop, asset prices, including real estate and equities, will trend higher," says Wong, whose firm runs an A-share China fund.

Another China bull is Tan Teng Boo, founder and managing director of Kuala Lumpur-based independent fund-management firm

Capital Dynamics Asset Management. Tan is bullish on Chinese stocks over the long term because he believes China will be the key driver of growth for the rest of the world over the next few decades. "If you have a one-year horizon, the [China stock] rally is overdone, although one can argue that the drop in 2008 was overdone too. If your investment horizon is five to seven years, then there is still more upside and the current rally is just the beginning. If the horizon is 20 years, I can imagine the Shanghai Composite Index making many, many new highs," enthuses Tan, who recently invested 25% of the assets of his new fund, the iCapital International Value Fund, in several Hong Kong-listed H-shares.



Young: It's a sharp liquidity-fuelled rally. The easy money is over.



Hang Seng China Enterprises Index



Shanghai Composite Index



Fund managers' China stock picks

Wong Kok Hoi, APS

Andrew Mattock, Henderson Global Investors

Tan Teng Boo, Capital Dynamics

Ju Teng International, Shanghai Jin Jiang and Tianjin Tasy Pharmaceutical Co

Guangzhou R&F and New World China Land

New World Department Store and Yip's Chemical

Stimulating growth

This isn't the first time a powerful fiscal stimulus in China has powered a spectacular market rally. In the past, stock-market rallies in China have been, more often than not, triggered by the government's market-friendly policies. To support its free-falling stock market, for instance, the Chinese government in September scrapped a stock-trading tax and allowed state-owned companies to increase holdings in their listed subsidiaries. Moreover, when China's economy hit a snag in 3Q2008 on the back of plunging exports, owing to a sharp fall in consumption in the US and Europe, Beijing was quick to unveil plans in November to re-engineer growth by rolling out the RMB4 trillion economic stimulus package, the bulk of which will be spent on infrastructure and social services over the next two years.

The spending binge in China has stoked domestic demand, countering a slump in exports. Indeed, the country's manufacturing production, measured by the China Purchasing

Managers' Index, expanded for a fourth month in July. Credit creation in China has also seen rapid growth, with bank loans surging from 14.6% y-o-y last October to 34.4% in June. Home sales in the world's third-largest economy, boosted by easily attainable financing loans, climbed 31.7% in 1H2009, pushing property investment from 1% in January to 18.1% in June. Automobile sales in China have been growing more than 50% y-o-y, making it the world's biggest and hottest car market.

"Over the past 12 months, we have seen a massive shift in policy as a result of what happened on the export side," notes Andrew Mattock, fund manager of the **Henderson Horizon China Fund**. "Very clearly, the policy changes have been focused on the domestic attributes of the Chinese economy, namely investment and consumption, as China makes the right effort in focusing on domestic economic growth rather than trying to get exports to recover. This is supportive of a longer-term, more sustainable growth path for China." His fund is the best-performing China-focused one in Singapore this year, having surged more than 100% since the start of January.

Yet, the speedy growth in credit creation and the sudden surge in asset prices are fueling concerns that banks are taking on too much risk. "Aggressive fiscal policy should be moderated with cautious banking policy," says Chua. "The world will be in big trouble if Chinese banks blow up in 2010 to 2011 as current

lending policies continue," he says. Indeed, he likens the current Chinese policies to Japan in the aftermath of Black Monday October 1987, when Tokyo rolled out aggressive monetary and fiscal policies to boost domestic demand, with banks lending wildly to stock and property investments. "The Chinese will make the same mistakes and face what Japan faced in due time as its banks' loans are steadily infected with [an accumulation of poor-quality and more bad loans]. I hope their policymakers realise the great importance of having solid, prudent and sound domestic banks before it is too late," Chua warns.

Most fund managers are betting that if asset prices and bank borrowings continue to soar, Chinese policymakers will spring into action at some point, leading to monetary tightening down the road. That could really spell bad news for China's stocks. "One real risk that confronts the market is monetary tightening," concedes Wong. But he reasons that the economic recovery in the China is still in its infancy and it is highly unlikely that its policymakers would "slam on the brakes" anytime soon. "Policymakers in China and the US have learnt from the Japanese experience of tightening too early," says Wong, who reckons that expansionary pro-growth policies in China will continue until 2010. "As the global economy is still fragile, I think policymakers will err on the conservative side." Henderson's Mattock concurs: "We are optimistic that Chi-

na will maintain its relatively loose monetary policy until the whole economy, including the housing sector, has achieved a solid recovery momentum."

Chinese stocks still have room to run

China's central bank said on July 29 that it would continue to maintain a "moderately loose monetary policy" to aid the nation's economic recovery. Wong believes the Chinese stock market will continue to trend higher for as long as economic policies in China "do not take a U-turn" over the next six months.

Although H-shares, the most common type of Chinese equities owned by global investors, have had a fantastic run this year, their gains aren't excessive, says Ivan Leung, Asia chief investment strategist at JPMorgan Private Bank. He points out that the performance of H-shares is very much in line with that of the MSCI Emerging Markets index, which has surged 51% since Dec 31, 2008. "From a relative perspective, the H-share run-up has lagged even stronger performers such as India, Indonesia, Brazil and Russia, despite China's having a superior V-shaped economic recovery," he says.

From a valuation perspective, Leung says Chinese shares still look like "fundamentally good value", in line with other stocks in Asia. "Granted, like every other asset, they are no longer extremely cheap as they were in March. There's nothing wrong with that," he says. "We are still at the beginning of a new economic cycle and investors can still capture the earnings upside, dividends and positive valuation re-ratings in coming years. In a growth-challenged world, superior Chinese growth should trade at a premium."

Henderson's Mattock believes the H-shares benchmark HSCEI could soon hit a target of 15,000 from its current level of 11,612 over the next 12 months, as earnings recovery takes hold. While he concedes the market looks fairly valued, Mattock believes investors are "starting to see a turnaround in earnings as the stimulus effects start to trickle into the Chinese economy". The early signs of recovery at Ebit (earnings before interest and tax) level look "very encouraging", he says, which should provide the market with good valuation support. Mattock believes that as earnings of Chinese companies are upgraded, their valuations will become cheaper and investors will be able to see value re-emerging. He says: "Given all the macro indicators we have seen, we are probably looking at mid-20% earnings growth or more. Based on our earnings growth expectations and a reasonable PER [price-to-earnings ratio] of 15 times, which is nowhere close to bubble territory, we would expect the HSCEI to climb to 15,000 over the next 12 months."

Valuations of domestic A-share counters in China aren't looking stretched either, argues APS's Wong. "Currently, the China A-share market is trading at a forward PER in the mid-20s, which is still reasonably inexpensive, given the broadening economic recovery, an improving corporate profit outlook and ample liquidity," he says.

While many find managers prefer the more accessible H-shares to mainland Chinese A-shares, Wong says the latter are now looking more attractive than the former. The APS China Alpha Fund — a long/short Greater China Fund — currently has substantial exposure to China A-shares. "The action and liquidity is in China; so, investors should stay invested in A-shares," he says. "Besides, there are more interesting and dynamic companies in mainland China" compared with a relatively limited number of companies in China listed as H-share firms.



Chua: The world will be in big trouble if Chinese banks blow up in 2010 to 2011



Wong: [China's] GDP will grow 8% to 9% this year with fixed asset investment contributing 5% to 6%



Tan believes China will be the key driver of growth for the rest of the world over the next few decades

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How to play China now

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Stocks and funds to bet on

Wong likes counters such as plastic casing manufacturer **Ju Teng International** and hotel operator **Shanghai Jin Jiang**, both of which are listed in Hong Kong, as well as Mainland-listed traditional Chinese medicine manufacturer, **Tianjin Tasly Pharmaceutical Co.**, all of which are benefiting from China's stimulus packages and are seen as key beneficiaries of the country's rapidly growing domestic demand. "Ju Teng is the largest casing manufacturer in the world, which we think will benefit from the recovery of the tech business worldwide and from the industry consolidation," he says. The stock is currently traded at less than 10 times FY2009 earnings.

Shanghai Jin Jiang is "a major beneficiary of the Shanghai Expo", a global exposition and trade show that opens next May. Shanghai Jin Jiang is trading at a fraction of its revalued book value, he says. Tianjin Tasly Pharmaceutical will benefit substantially from a new round of reforms in social welfare and a medical insurance scheme in China. Beijing has targeted RMB850 billion in social welfare spending over the next three years. The company is expected to deliver 20% to 25% growth a year over the next three years, says Wong.

Mattock's biggest bets are Chinese property counters. He doesn't believe China's asset prices, particularly real estate, are reaching bubble proportions. "The pick-up in transaction volumes shows the effectiveness of the measures introduced to stimulate demand for property," he says. "Longer term, we are positive on property because it forms a very significant part of fixed-asset investment in China and its demand is underpinned by structural changes taking place in the Chinese economy such as urban migration, a rising middle class and increased affordability."

Mattock is bullish on Chinese developers such as **Guangzhou R&F** and **New World China Land**. Guangzhou R&F, which develops, sells and leases property in Guangzhou and Beijing, has aggressively built a decent-sized land bank with debts. Looser monetary policy in China has provided the fast-growing property firm with easier access to credit and Mattock says its earnings are likely to be supported by signs of improvement in land-volume sales that have emerged. New World China Land develops and invests in properties in China and has a land bank of 19 million sq m, a large portion of which was acquired about 10 years ago, implying lower land cost compared with its peers. "Mattock expects the company to benefit from rising prices and transaction volumes."



Mattock: We will view market pullbacks as opportunities to build up the portfolio for future returns

Performance of China-focused funds and ETFs sold in Singapore

NAME	YTD RETURN (%) (DEC 31, 2008 TO JULY 31, 2009)		ONE-YEAR RETURN (%) (JULY 31, 2008 TO JULY 31, 2009)		THREE-YEAR RETURN (%) (JULY 31, 2006 TO JULY 31, 2009)		FIVE-YEAR RETURN (%) (JULY 30, 2004 TO JULY 31, 2009)	
	VALUE	RANK	VALUE	RANK	VALUE	RANK	VALUE	RANK
EQUITY CHINA								
Allianz RCM China - A - USD	60.14	1	13.58	1	76.79	2	139.23	2
DWS China Equity A SGD	54.55	5	13.19	2	88.73	1	-	-
Fidelity Funds - China Focus A	52.80	6	10.72	3	65.27	3	162.26	1
Lyxor ETF China Enterprise (HDCEI) B	57.44	3	4.41	4	-	-	-	-
HSBC GIF Chinese Equity AD USD	47.21	8	0.41	5	37.09	4	105.22	3
Aberdeen China Opportunities SGD	57.50	2	0.23	6	21.07	6	58.56	5
db x-trackers FTSE/XINHUA CHINA 25 ETF	50.03	7	-0.58	7	-	-	-	-
Parvest China C	45.42	9	-4.10	8	28.81	5	85.74	4
Celsius China Accelerated Growth USD A	55.74	4	-17.19	9	-	-	-	-
Equity China average (9)	53.43	9	2.30	9	52.96	6	110.20	5
EQUITY GREATER CHINA								
Henderson HF China A2 USD	107.42	1	47.71	1	-	-	-	-
Fidelity Funds - Greater China A USD	52.12	4	9.43	2	33.86	7	78.48	10
ING (L) Invest Greater China P Cap	49.75	9	9.01	3	43.73	2	102.49	4
SGAM Fund Equities China AC	50.42	7	6.36	4	40.43	4	107.56	3
Templeton China A Acc USD	50.17	8	6.33	5	42.15	3	90.00	8
SGAM Golden China USD	49.45	10	5.5	6	31.21	9	95.34	7
Schroder ISF Greater China A Acc	52.20	3	5.49	7	34.51	6	96.06	6
Schroder Greater China	51.42	6	5.05	8	31.69	8	89.95	9
LionGlobal China Growth SGD	46.27	13	3.82	9	40.32	5	124.64	1
First State Regional China SGD	51.80	5	2.25	10	48.65	1	116.72	2
Shenton Greater China	46.20	14	1.88	11	2.15	14	42.36	13
International Opps Fds Greater China Equity A	59.35	2	1.01	12	14.55	13	-	-
United Greater China Fund	46.85	12	0.85	13	22.00	10	96.18	5
Fortis L Equity China Cap USD	47.09	11	-0.64	14	21.08	11	62.88	11
AllianceBernstein-Greater China Portfolio A USD	43.17	15	-8.15	15	15.22	12	58.25	12
Equity Greater China average (15)	53.58	15	6.39	15	30.11	14	89.30	13

Tan of Capital Dynamics likes H-shares such as retailer **New World Department Store** and chemical products and solvents manufacturer **Yip's Chemical**. New World Development's balance sheet is strong and it currently operates 33 stores in 17 cities, Tan says. "It has grown rapidly and still has the whole of China to tap. Yet, it is selling at a PER in the mid-teens. It is hard to find such an attractive stock." Yip's Chemical is cheap as well, since it is trading at single-digit earnings multiples, says Tan, whose funds are also invested in Hong Kong/China names such as **Bank of East Asia** and **Beijing Capital Land**.

Stocks aside, investors can also take exposure to Chinese equities through China-focused single-country mutual funds and exchange-traded funds (ETFs). Given that China's stock market is not an efficient one, managed equity funds had historically outperformed the market av-

erages. In Singapore, there are pure China equity unit trusts and more than a dozen Greater China funds, which invest in Hong Kong, Taiwan and China, to choose from.

So, how should Singapore investors play China now? If they believe that China will outperform the region, then a China fund or an ETF will be the easiest solution, says JPMorgan's Leung, who reckons that China, along with India and Indonesia, will be the best-performing markets in Asia over the next few years. "During the past few months, many clients have preferred to select individual core stocks... but, going forward, we think active management would be a better solution for clients who are not so close to the market," he adds.

Aggressive fund investors who have the stomach for volatility but like their gains magnified could consider the red-hot Henderson Horizon China Fund, which is a "130/30"-type long/short fund, with the ability to leverage its long positions to maximise the gains when markets are trending up and the flexibility to short the markets during a downtrend.

Mattock says the Henderson Horizon China Fund will probably continue to beat its benchmark and peer funds based on "a proven" long/short strategy, if the Chinese stock markets continue to trend higher over the next 12 months. "Should the earnings momentum prove to be unsustainable and when things do become frothy, our fund also has the added flexibility to buffer some of the downside as it can reduce net market exposure [by buying] a put option on the index when volatility levels are high," he adds.

Using short-term corrections to add positions

Given the strong rally that Chinese equities have experienced since end-October last year, Mattock says he would not be surprised to see some correction in the near future. "But we will view market pullbacks as opportunities to build up the portfolio for future returns," says

the optimistic fund manager. Leung says any short-term corrections in the Chinese stock market or any other Asian markets will be short-lived because of the massive cash sitting on the sidelines, waiting to enter the stock markets during dips.

"While many Asian equity markets are showing signs of being short-term overbought and August is seasonally a poor month, far too many investors have missed the last few months of returns by holding too much cash," he notes. "So, while there's a likelihood we will face a short-term technical consolidation, medium- to longer-term investors really need to be invested in the China story." The way he sees it, an influx of funds into China will continue to drive the market. New China-themed ETFs as well as new funds that will be listed in China in the near future would be just a few more "sources of massive liquidity and demand" for Chinese stocks.

Despite being cautious on Chinese stocks, Chua has hesitated to exit his long positions in China's indices. He says he will gradually liquidate his "in the money" long positions and "stay on the sidelines" as the China stock bubble gets bigger. "The higher it goes, the more severe the inevitable correction," he warns. For now, he is betting that "it is not wise to go against millions of gambling Chinese with government policies cheering them on." Legendary investor Jim Rogers, who authored the book *A Bull in China*, remains cautious for the short term but bullish on China investments over the long term. While he hasn't been rushing to take profit on his China gains, he too isn't in a buying mode right now.

Aberdeen's Young has his eyes glued on the big picture. All bubbles eventually burst. China's stock bubble may not pop next week or next month, but it will. The key is to keep a close watch on the signs that it is getting out of hands. Mistaking green shoots for a rainforest could be costly for investors.



Leung reckons China will be among the best-performing markets in Asia over the next few years