



China Policy Research

Generating Alpha from Chinese Policy

How Government Action Drives Returns

INTRODUCTION

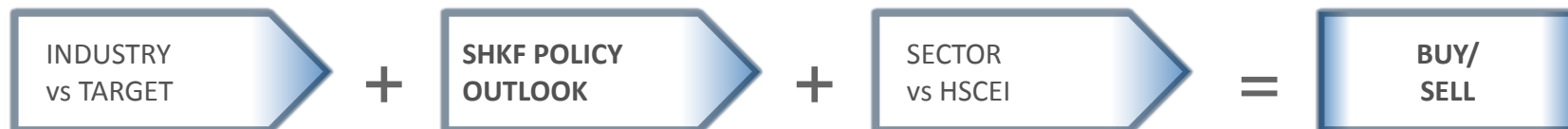
The Model:

- **INPUT 1: CHINA'S INDUSTRY TARGETS**
Use sectors based on government FYP and other targets
- **INPUT 2: CHINESE GOVERNMENT POLICY OUTLOOK**
Assess whether positive, neutral or negative towards sector based on Beijing analyst research
- **INPUT 3: HONG KONG and CSI 300 SECTOR STOCK MARKET PERFORMANCE**
Indicates under/overperformance and potential reversals
- **OUTPUT: PERFORMANCE**
Generates above-market returns on a consistent basis, identifying key reversal points
- **OUTPUT: SECTOR EXAMPLES**
Current sector performance and recommendations
- **OUTPUT: SECTOR RECOMMENDATIONS**
Individual sectors

SHKF's Expertise:

- **GOVERNMENT INFLUENCE: Decisive factor for investment**
Government owns the major companies in strategic sectors and controls economy and industry targets and performance
- **KEY STRENGTHS: Chinese focus and expertise**
Experienced executive team with growing pool of Chinese analysts and industry advisors
- **SHKF's BEIJING BUILD-OUT: Nine-year development**
Beijing office provides on-the-ground insight and contact with policy decision-making arena

- **Chinese government policy is a decisive factor in investment in China.**
 - Can be viewed as a market leading indicator for key sector up and downturns
- **SHKF has been tracking Chinese government policy for almost a decade** and we understand its influence, timing and importance for key sectors
 - In-depth knowledge and insight into sector moves and government shifts
- **Our Chinese Government Policy Model integrates three elements to generate key sector recommendations:**
 - industry performance
 - policy outlook
 - stock market performance
- **This generates key BUY and SELL signals for main China sectors**
 - Long-only can use it to overweight/underweight sectors
 - Hedge funds can long/short key sectors
- **Consistent outperformance vs the HSCEI over time**
 - Over the past year, our selection of sectors would have outperformed by an average of 21.1%



INPUT 1: GOVERNMENT TARGETS BY SECTOR

1. **Identify sectors and annual targets according to China's Five Year Plan**
 - e.g.: rail, roads, power generation, autos, rather than MSCI or FTSE sectors
2. **Identify key monthly sector targets:**
 - need to be on a monthly basis with regular updates
 - one target per sector at present
3. **Use key sector targets as overall industry forecasts**
 - Monthly targets calculated for each sector based on 5-year previous seasonality (where applicable)
4. **Measure over or underperformance of actual vs target on a monthly basis**
 - Sector constituents chosen to correspond with Hang Seng China Index and CSI 300
 - Above US\$1bn market cap
 - Liquid
 - PURELY QUANTITATIVE ELEMENT

SHKF Sector	FYP Target
Banks	Money supply
Insurance	Premium target
Oil	Production target
Coal	Production target
Power Generation	FAI
Thermal Power	Production target
Wind Power	FAI
Steel	Consumption target
Copper	Production target
Aluminium	Production target
Autos	Sales target
Railways	Rail FAI
Airlines	Freight Ton km
Property development	Real estate Investment
Construction	Real estate and infrastructure Investment
Telco Equipment	FAI
Telco Operators	Revenue target
Gas Distribution	FAI
Water conservancy	FAI
Healthcare	Individual healthcare spending

SHKF Sectors based on Chinese government FYP

- **Identify whether government policy is supportive, neutral or negative towards the sector**
 - **Conclusion derived through in-house research in Beijing**
 - Not just from a propaganda angle

- **Large banks** are seeing improving credit quality on a stronger economy and are well-positioned relative to smaller banks that are more exposed to the financial regulators' actions on NCD funding and WMPs.
- **Water** has seen consistent and financially effective policy support with a timetable of future investment-promoting fee increases to come
- **Healthcare** benefits from both burgeoning urban middle class consumption and government support under the 13th Five Year Plan. Within the sector we prefer **drugs distributors, medical device makers** and **biopharma firms**.
- **Industrial automation** benefits from China's strategic policy vision to upgrade manufacturing and nurture new tech sectors via the Made in China 2025 initiative, as well as from government measures to encourage greater private investment.
- **Property sales** are expected to slow on higher mortgage rates.

KEY CONSIDERATIONS

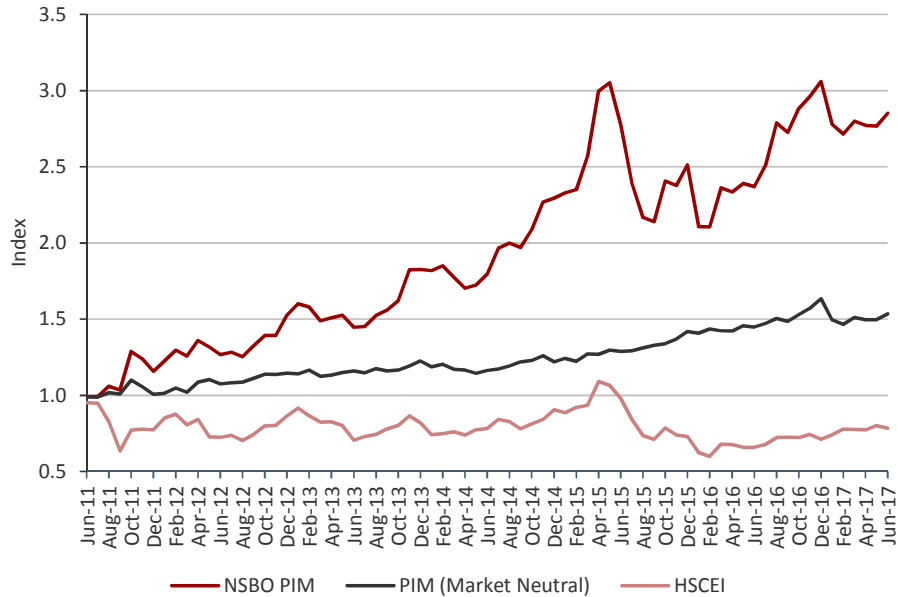
- Timing of policy?
- Which department/ministry?
- Superseded by other policy?
- Financial support for policy?

- Assess relative sector performance to HSCEI, MSCI-China and CSI 300 on a monthly basis
- Use this in tandem with industry and policy positions to give investment outlook for each sector.
- PURELY QUANTITATIVE ELEMENT

- **If a sector is**
 - a) **underinvested/underachieving** its targets and
 - b) the **policy is positive** (an increase in support) and
 - c) the **market performance is underperforming**, then this is likely to lead to a turnaround in the sector and the **investment outlook is a STRONG BUY (indicates turning point)**.
 - If the same situation applies, but the industry has **outperformed**, then this is a **BUY (indicates continuing trend)**.
- **If the sector is**
 - a) **overinvested/overachieving** and
 - b) the **policy is negative**, with
 - c) the **market performance is outperforming**, then this is likely to lead to a turnaround in the sector and the **investment outlook is a STRONG SELL (indicates turning point)**.
 - If the same situation applies, but the sector is **underperforming**, then this is a **SELL (indicates continuing trend)**
- **All other outcomes are NEUTRAL.**

Industry Actual vs Target	Policy Support	Sector Performance	Outcome
Underinvested/ underachieving	Positive	Underperform	Strong Buy
		Outperform	Hold
	Negative	Underperform	Hold
		Outperform	Sell
Overinvested/ overachieving	Positive	Underperform	Buy
		Outperform	Hold
	Negative	Underperform	Hold
		Outperform	Strong Sell

POLICY RECOMMENDATION PERFORMANCE



- Generated above market returns on an annual basis
- Identifies key reversals in market performance
- Long-only – underweight/overweight sectors
- Hedge funds – long/short
- Used to identify key entry points – recommendation not continued next month if return is achieved

Absolute returns

June 2017	Month	Qtr	Annual		2016	2015	2014
PIM (%)	2.5	2.7	21.6		15.2	5.6	32.2
HSCEI (%)	-2.2	0.9	19.0		-2.8	-19.4	10.8
CSI 300 (%)	5.0	6.1	16.3		-11.3	5.6	51.7

Source: Bloomberg, SHKF

INVESTMENT CALLS OVER THE PAST YEAR

Key H – H-share buy; **h** – H-share positive; **H** – H-share sell; **h** – H-share negative; **A** – A-share buy; **a** – A-share positive; **A** – A-share sell; **a** – A-share negative; Note: only buy and sell recommendations affect investment results

DD – drugs distributors, MD – medical devices, Bio - biopharma

	Sep-16	Oct-16	Nov-16	Dec-16	Jan-17	Feb-17	Mar-17	Apr-17	May-17	Jun-17	Jul-17	Aug-17
Water	h/a	H/A	h/a	H/A	H/a	h/a	H/a	h/a	h/a	H/A	h/A	H/a
Telco	H											
Property		H/A	h/a	H/A	H/A	H/a	h/a	H/a	H/a	h/a	h/a	H/a
Constr	H/a	H/a	h/a	H/A	h/a	H/A	H/A	h/A	H/A	h/a		
Steel	H/a	H/a	h/a	H/A	H/A	H/A	H/A	h/a	h/A	h/a		
Large Banks											h/A	H/a
								DD	H/a	H/a	h/a	h/a
Healthcare	h/A	H/h	H/A	H/A	h/a	h/A	H/A	MD	h/A	h/A	H/a	h/a
								Bio	H/a	h/a	h/A	h/a
Solar/Wind							H/A	h/a	h/a	h/a	h/a	h/a
Aluminium	h/A	H/A	h/a	h/a								
Ind autmtn									h/A	h/a	h/a	h/a
Gas Distr			h	h	H	h	h	H	h	h	H	h
RESULT (%)	-1.8	+4.3	+1.9	+3.3	-7.4	-2.0	+4.3	-0.1	0.1	2.5	-2.6	
VS HSCEI (pp)	-2.2	+4.5	-1.0	+7.8	-11.7	-7.0	+4.5	+0.7	-3.6	4.7	-7.1	
Vs MSCI CH (pp)	-4.0	+6.3	+3.1	+7.5	-14.2	-5.6	+2.0	-2.6	-5.1	-2.5	-11.0	

London Office

- Provides regular client contact, feeding investment ideas and recommendations to clients in London, Europe, Hong Kong, and New York
- Head of Research and Chief Strategist operate primarily from the London office to produce our policy-driven investment thesis

Hong Kong Office

- Sector-specific senior analysts providing bottom-up research and on the ground trading ideas
- Trading execution desk with access to all non-ID Asia markets

Beijing Office

- Sector-specific China analysts on the ground in Beijing providing daily reports on policy movements
- Growing pool of academic/think-tank advisors to give policy insight & direction

Shanghai Office

- Primary location of parent company China Everbright Group
- Access to China Everbright research and trading ideas to supplement our top-down policy research from Beijing

Rafael Halpin, Head of Research

Prior to this he was Head of Research at FT Confidential Research, the Financial Times' emerging markets research service, where he worked for four years. He headed up their macro research into China, and developed the company's proprietary surveys of consumers and corporates in key emerging markets. He previously lived and worked in China as the China analyst for a commodities consultancy. Rafael is a graduate of Oxford University.

Duncan Wrigley, Chief Strategist

Before joining NSBO (now SHKF) in 2013, Duncan worked for seven years at Shui On Land in Shanghai, where he managed economic and real estate analysis and provided inputs into management's strategic and investment decision-making. Before that, he worked at the Economist Group in Hong Kong and London, Business Monitor International in London and the Center for Strategic and International Studies in Washington DC. He is a graduate of Johns Hopkins University School of Advanced International Studies and Oxford University.

Richard Abrahams, Head of Institutional Equities

Before founding North Square Capital in 2008, Richard was CEO and Head of Trading at Pali International, where over his tenure the firm established itself as a leader in event-driven equity research and execution. Prior Pali, Richard was head of equity of HSBC in the US.

SHKF Research Capability

- Beijing office provides **research, insights and policy interpretation.**
- Feeds through **into sector and company analysis** from policy perspective.
- Investment idea generation** and trading calls in London based on policy and industry analysis.

SHKF Beijing Office

- **Team of analysts** in major policy sectors
 - Financials
 - Energy
 - Property
 - Water
 - Construction
 - Steel

SHKF's Chinese Research Time line

2007

Set up office in Beijing – research development and advisory network

2008

Launched Chinese government policy research from London

2009

Blue Oak merges with North Square in London to build up sales representation and capacity

2011

Widened client focus to Hong Kong and New York, as well as Europe

2013

Launched Policy Investment Model to generate consistent above-market returns based on sector policy outlook

2015

Partnership with Sun Hung Kai Financial / Everbright International to broaden distribution

2017

Sun Hung Kai Financial / Everbright International acquires NSBO

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