UBAM – best selection China A

Quarterly Comment | Q1 2021

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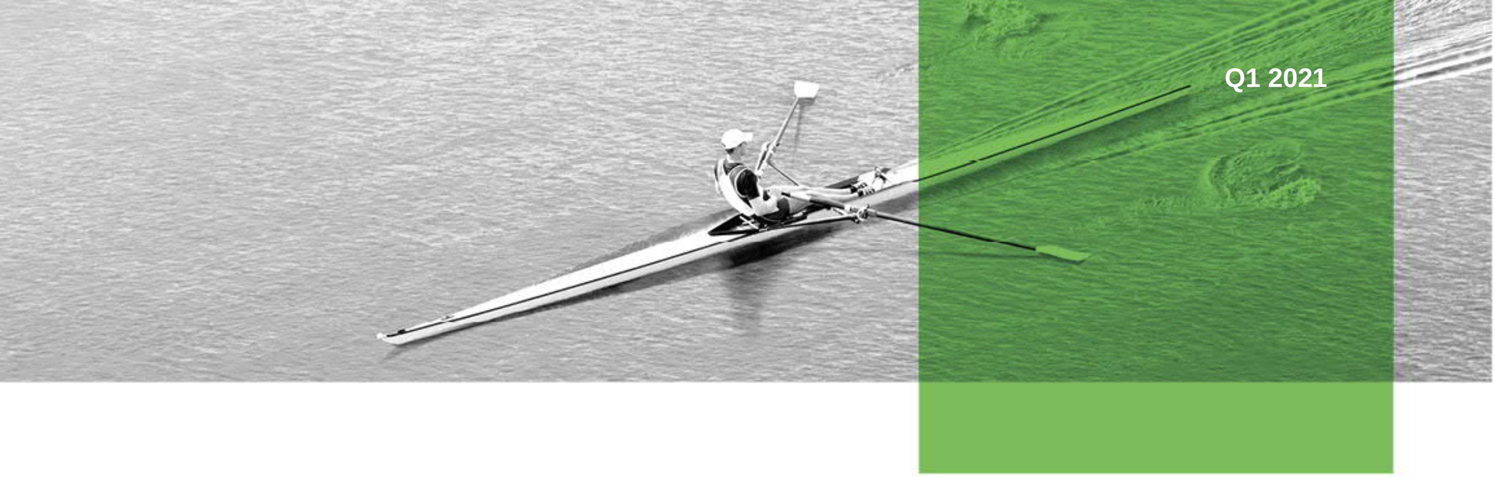
Market Comment

- Investors were very optimistic at the turn of the year, but quickly saw several risks appear on their radar screens. Investor sentiment deteriorated from mid-January onwards because of the spread of new coronavirus variants, slow vaccination roll-outs in Europe and the possibility that the new US president's stimulus package would be reduced in size. Observers were also concerned about extreme price movements in some stocks, driven by hordes of retail investors. In the end, most equity markets fell slightly during January, although some large Asian markets strongly outperformed.
- The financial markets continued to reflect investor optimism about the upturn in economic output and corporate earnings. For the first quarter of 2021, the S&P 500* posted a return of 6.05% and hit new all-time highs. The technology sector underperformed, which meant that European markets fared even better: the MSCI Europe* returned 8.35% with strong gains for both cyclical and defensive stocks. However, many emerging markets lost ground in March, usually for country-specific reasons. For example, the Chinese and Turkish markets both fell 6% during the month and the MSCI Emerging Markets* in USD finished the quarter with a performance of 2.29%.
- Volatility has returned to Chinese equity markets: after rallying 90% from its trough in March 2020 to a peak in February 2021, the MSCI China has fallen by 16% in the last month. This volatility has been driven by a combination of cyclical concerns, as Chinese policy has slowly begun to normalise increased regulatory/anti-trust pressures from the domestic Chinese authorities, as well as geopolitical tensions. Cyclical concerns are probably overstated, as China has no need to tighten policy as dramatically as it did in 2011 or 2015, given the more modest pandemic-related stimulus in 2020.
- Looking at mainland-listed A-shares, cyclical earnings prospects look set to benefit not only from the cyclical economic expansion under way, but also from the domestically focused transformation set to be spurred on by China's latest five-year plan. Indeed, even just assuming a cyclical earnings recovery, China A-shares are now trading below mid-cycle P/E ratio multiples, suggesting earnings- and P/E ratio-driven performance catalysts lie ahead.

Sources: UBP, Bloomberg Finance LP.

All performance figures are given net of fees. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

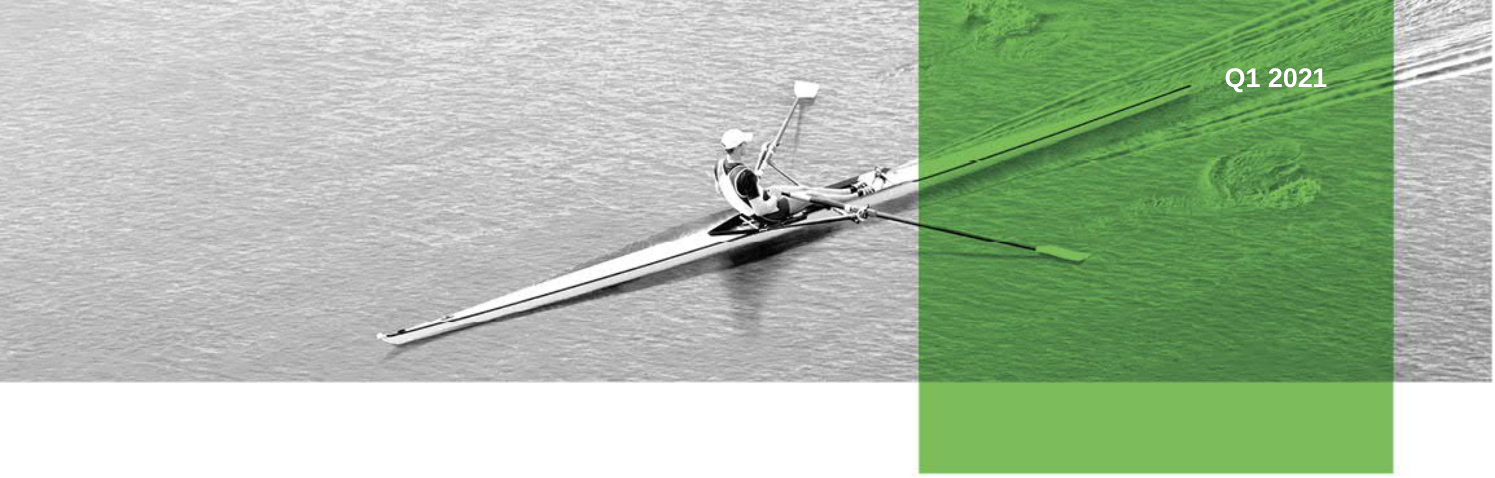


Performance Review

- During the first quarter, the strategy underperformed the MSCI China A NR. Sector allocation contributed, but stock selection detracted.
- After a strong year in 2020 which saw a very good year for China A and for the strategy. The market has become slightly more volatile during the first quarter of 2021
- Our overweight position in Materials contributed to performance while our overweight exposure to Financials detracted.
- Despite the negative allocatrion effect, our stock picking within Financials helped us generate alpha. China Merchant Bank and Bank of Hangshou were the main positive drivers.
- The option market and our volatility model are key sources to construct volatility surface. Chinese market's option-based derivatives have been developed rapidly in recent years, providing us more local listed options as well as OTC single stock options. Our in-house AI model has been developed to provide us with the calculation future volatility of options and equities, and it has been improving all the time with more option contract issued.
- The introduction of options on the CSI 300 has also been beneficiary for the strategy has it provides more evidence to derive single stocks volatility patterns.

Portfolio Activity

- Like in the fourth quarter of 2020, during the first quarter of 2021 we maintained the same number of stocks in the portfolio. The equity allocation did not change drastically during the quarter and was kept above 90%. The position was little changed because the volatility was low, but also because we wanted to keep a low turnover rate.



Outlook

- Growth expectations were revised higher after US President Biden's fiscal package was passed through Congress, whilst high frequency data released during the quarter was also impressive. For example the March jobs report in the US saw an almost 1mn increase in payrolls, whilst global PMIs rose to a cycle high and led investors to price in more hawkish policy from the Fed in particular over the coming years. Despite this, central banks continued with their dovish tone, emphasising their commitment to maintain accommodation until economies have fully recovered from the pandemic. As we look ahead to Q2, the focus will be on whether vaccine distribution will allow economies to begin reopening, or if any vaccine rollout delays or virus mutations will slow reopening plans. Central banks will also be closely tracked to see if they begin to react to the consistent strength in the data and start guiding towards a less accommodative policy stance down the line.
- We remain constructive on Chinese equities, which underprice the cyclical recovery ahead, even though the Chinese equity market has recently been under pressure. Still, we believe that authorities have little reason to tighten aggressively. Regulatory concerns also weigh on investors' sentiment, but the potential negative impact of anti-trust measures (which are positive in the long-term) look increasingly priced in among China Big Tech stocks. Domestic consumption, technological innovation and further financial reform should create opportunities for investors looking to benefit from China's long-term growth prospects.
- The combination of a large pool of opportunities – there are over 3,000 listed companies in China – and the inefficiencies in the market – it is driven by retail investors – means there is considerable scope for institutional investors to outperform the broader market.
- With this in mind, our team is focusing on finding companies with the relevant volatility pattern and only investing in their strongest convictions, with the aim of outperforming the MSCI China A index on a sustainable basis. As the Chinese stock market remains less mature than those in the developed world, rigorous analyses and strict risk-management are vital to help us achieve this goal.

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