Flash Market Update 30 July 2021

Chinese Government Crackdown: Implications & Opportunities

What's Happening in China?

Educational reforms, and crackdowns across the wider economy.

Just last week, the Chinese government issued major educational reforms. The latest salvo has two key thrusts, known as the "double-reduction" which aims to:

- Reduce the homework burden arising from compulsory education, and
- Reduce off-campus training burdens arising from attending non-compulsory cram schools.

Regulatory efforts across the wider Chinese economy have also been seemingly fast and furious. Two other significant announcements have been made, the first of which was issued by the Chinese Ministry of Industry and Information Technology regarding a new six-month campaign to crackdown on internet misconduct. The other came in the form of a guideline to protect the rights and interests of food delivery workers.

Unsurprisingly, these developments prompted a sharp sell-off across the private education and tech sectors. But contagion effects have also spurred a broader sell-off:

July MTD Performance (as of 7/29/2021)	
New Oriental Education & Technology Group	-73%
TAL Education Group	-77%
KraneShares CSI China Internet ETF	-26%
MSCI China Index	-12%
CSI 300 Index	-7%

Source: Bloomberg, returns in USD

Note that our portfolio allocation to China 'A' (CSI 300) holds no education providers, as it is a small segment of the entire China 'A' universe. This is one reason why our diversified investing approach is preferred, as it allows us to participate in attractive markets i.e. China while going through a less stressful journey.

Our Take on the Situation

The financial impact of China's educational reforms on the private education sector is profound and likely to be lasting. It is also hard to predict if these reforms will be rolled-back anytime soon or in the foreseeable future. As long-term investors, we do not want to make 'bets' that rely on futile predictions. Instead, we focus on the opportunities abound in the broader market that still benefits from clearer tailwinds in the economic climate and growth in China.

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Our Positioning and Outlook

We had reduced our exposures to China 'A' in the early parts of July, as we observed less accommodative policies and headwinds to corporate earnings in the near-term – this has helped our portfolios avoid larger drawdowns in the past week.

We continue to maintain a smaller position in China 'A', as the medium-long term picture remains positive e.g., attractive relative valuations, and supported by earnings growth. Chinese policy makers have also taken steps to calm the markets more recently; with a meeting between their securities regulator and executives of major banks. Earlier in the month on 15th July, the People's Bank of China (PBOC) also surprised markets by lowering the reserve requirements (RRR) for banks to better support their economy. In general, the PBOC has more tools or 'firepower' at their disposal to tighten or stimulate the economy if things get out of hand either way – this is likely to be a net-positive compared to other central banks who may find their hands tied.

Portfolio Performance

While our portfolios were not directly impacted by the recent crackdown, it was not spared from the broader sell-off. In fact, some astute investors may ask why the world equity indices/benchmarks (which are US-heavy) have seemingly fared better? Perhaps the following performance table can help provide some clarity:

Performance (as of 7/28/2021)	MTD	YTD
S&P 500 Index NR USD	2.46%	17.82%
MSCI Asia Pacific ex. Japan Index NR USD	-7.48%	-1.16%
MSCI China Index NR USD	-15.83%	-14.28%
CSI 300 Index NR USD	-9.12%	-7.11%
finexis model portfolio Aggressive SGD	-3.06%	3.64%
finexis model portfolio Balanced SGD	-2.14%	1.71%
FAM Millennium Equity (FME) A USD	-6.66%	-
FAM Global Opportunities Plus (FGOP) A USD	-4.52%	7.07%
FAM Global Opportunities (FGO) A USD	-3.09%	3.92%

Source: Morningstar, FAM. All returns net of fees in USD except finexis model portfolios which are shown in SGD gross returns.

The table above shows that the only positive MTD and YTD return is the US S&P 500. We do not think that the recent strong performance is sustainable, especially as performance is increasingly driven by a narrow group of mega-cap tech stocks. **Historically, investing at the current high valuations is a good way to get extremely poor annualized returns over the subsequent few years.**

In contrast to the S&P 500, our portfolio performance may seem underwhelming even though it did better than Asia and China equities. The fact is that we had avoided investing in the broader US market i.e. S&P 500. Instead, we have positioned ourselves in areas with more room to recover i.e. US small-caps, Europe, and the broader Asia and EM markets – all of which provides better valuations, and with more potential for earnings to grow especially as economies continue to reopen. **Our investment philosophy and process of investing into opportunities with better 'FVT' (fundamental, valuation, technical) results in a forward-looking portfolio that is expected to have higher future returns – in our view, the appropriate reaction to such temporary declines would be to buy the dip. Our long-time investors know that such deviations in performance are expected, but result in a more rewarding journey for us in the end.**