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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Investing in Asia: Why China? Why Now?

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SECTOR — GENERAL INVESTING

TWST: Could you tell me about the firm?

Mr. Morton: We're a value investor in Asia with a strong skew to income-oriented equity and focused on finding cheap securities with a margin of safety that also generate strong, sustainable growing cash flow and throw off attractive dividends that give our investors an exceptionally high yield in these current income-starved environments. Our portfolios are currently yielding somewhere between 6.5% and 7%, which for equities in Asia is a pretty interesting number.

TWST: And did you want to highlight what's been going on in Asia in the last six months? And what do you expect might happen in the coming year?

Mr. Morton: Well, it's been a truly extraordinary year. Of course, we all know that.

Asia has weathered the storm rather better than most, although one has to differentiate between different parts of Asia, because, after all, we're talking about half the world, essentially.

Of course, the most dramatic event of the year is the COVID-19 virus. China was hit hard first, but has recovered, essentially, completely at this point. The country still experiences the odd outbreak. But I see Bloomberg News making a major headline out of eight new cases in Shanghai and there are over 20,000 new cases a day in most European countries. I slightly wonder about the relative perspective of why eight in Shanghai is so dramatic — a number that it deserves star billing — when such a big number in other parts of the world doesn't even get mentioned.

I think Asia has been unfairly singled out here, because actually, the Chinese economy is back to a growth trajectory. The new targets for growth in China are 4.5%, 5%, if you translate the objectives of the party for the country into a number. And that's true, I would say, for most every country around North and East Asia, Japan, Korea, particularly Taiwan, Vietnam and Singapore, where I live. We haven't had a domestic case of COVID now for some time, although we still get a lot of imports from other countries, but of course, in our quarantine.

So what you're seeing across this region is a general recovery from a disastrous first quarter, pretty terrible Q2. Now, as I said, it's not same story everywhere. If you look at Vietnam and Thailand, they supposedly don't have any cases, but the situation is different. In Indonesia and Philippines, for example, where the data I would say is less reliable and they're still experiencing difficulties, although some modest recovery from the very bottom. And India is also hard to track. India, Pakistan and Bangladesh are on a different trajectory. There's still, I think, fairly active COVID going on there.

But if you look at the markets, they've kind of reflected that and in terms of China, domestically, the index is up a lot this year, reflecting the strength of the economy and also to some extent the composition of the various indices with a lot of technology. Hong Kong, which has a much more traditional composition to its indices, although even there now, we're seeing a reasonable tech element, that's still down at the moment — 4%, 5% down — and there are still a few cases unfortunately there.

So the market is reflecting the resurgence or lack of resurgence in the economic activity in the region. The worst hit markets — Thailand, Indonesia, Philippines — they've been amongst the best-performing markets since the news of a realistic chance of vaccines hit the global media.

And on that point, we know China has been vaccinating people since June. We were hearing about it in August, from companies we were doing our half-year reviews with, and they were talking about the fact that their sales engineers and construction managers on projects around the world were all being vaccinated. The media has not really covered this.

There was an article the other day in *The Guardian* which mentioned that, at a recent press conference, a Chinese minister had said over 1 million people were being vaccinated without any adverse side effects from the Sinovac vaccine. I don't know how to interpret that. My belief is it's a much bigger number of people. And I don't know — I'm certainly no vaccine expert, so I don't know what side effects may or may not have been measured — but I do think that it seems to be a reasonably good solution.

And Indonesia is due to start vaccinating 5 million people a month in theory in January. Under license, they are manufacturing the Sinovac locally in Malaysia, also in Quarter 1. And those are the ones we know of and I'm sure there will be more.

So if we talk about the difference between this year and next year, the biggest single one should be that a lot of people are going to be vaccinated and although that doesn't mean things are entirely back to normal, they are headed in that direction. And in some places, they are. In China now, we see pictures from, not from state media, but from private sources, that people are out there not wearing masks at restaurants and socializing to a pretty large extent and we know from the companies we invest in that things, with certain exceptions, are pretty much back to normal. Down in Australia the same.

Highlights

James Morton discusses investing in East Asian markets, with a focus on two out-of-favor sectors in China: banks and property. Mr. Morton points out that Asia is ahead of many other parts of the world when it comes to beating COVID and that a range of Chinese companies are back showing year-on-year growth. He believes it will be easier to find earnings growth in China than in some other parts of the world where the economies are still faltering due to the pandemic. With the exception of tech stocks, Mr. Morton believes Shanghai and Hong Kong markets are cheap, in both absolute and relative terms. He also notes that while Asia has traditionally been considered the place to go for growth, it is increasingly a place to look for income, pointing to 2020's Hong Kong market for its consistent dividend payments. He also notes that China will be making an effort to improve the quality of its bond market and make it more accessible to global investors.

Companies discussed: JChina Merchants Bank (SHA:600036); Agricultural Bank of China (HKG:1288); Bank of China (HKG:3988); Chongqing Rural Commercial Bank (SHA:601077); China Evergrande Group (HKG:3333); Sunac China Holdings Ltd. (HKG:1918); Guangzhou R&F Properties Co Ltd. (HKG:2777); Greenland Holdings Corp Ltd. (SHA:600606); Yuexiu Property Co Ltd. (HKG:0123); Supalai PCL (BKK:SPALI); Longfor Group Holdings Ltd. (HKG:0960); China Resources Land Limited (HKG:1109); China Vanke Co Ltd. (HKG:2202); Times China Holdings Ltd. (HKG:1233); Powerlong Real Estate Holdings Limited (HKG:1238); Yuzhou Group Holdings Co Ltd. (HKG:1628); KWG Group Holdings Ltd. (HKG:1813) and CIFI Holdings (Group) Co Ltd. (HKG:0884).

TWST: And do you think the Asian economies, particularly in China, might benefit from the Biden presidency? Will it be either a thawing of relations or warmer relations in terms of trade?

Mr. Morton: Sadly, I don't think the Biden presidency will make much difference in that respect in terms of substance. In tone, I'm sure there will be a huge difference. Biden has a history of trying to seek agreement across the aisle and building consensus and working with parties constructively, and the tone and tenor of his administration I think will be dramatically different than that of the outgoing president. It will be less confrontational, and probably will achieve more.

In substance, I mean, for example, we've just had the Regional Comprehensive Economic Partnership, which is one of the most important things to have happened to this part of the world for some time, signed off by all the countries in the region, creating the largest free trade zone in the world. Now, how it works in practice, we'll have to see. But the point is, this is a kind of resurrection of the Trans Pacific Partnership with a few extra bells and whistles that President Trump walked away from.

And of course, it now doesn't include America, but it does include China, which is not what the original intention was, and also it includes promises to actually regularize and conform the treatment of intellectual property across these nations. Now, this was one of the objectives of Trump's negotiating team to get Chinese concessions in this area and they never did. But here we have countries as diverse as Australia, Singapore, Japan, China and Vietnam, all signing off on something. Again, we'll see what actually happens. They've got 10 years to do it, which is a long time. But in theory, there's agreement on an issue.

"So if we talk about the difference between this year and next year, the biggest single one should be that a lot of people are going to be vaccinated and although that doesn't mean things are entirely back to normal, they are headed in that direction. And in some places, they are."

So this part of the world, we haven't beaten the virus and I don't suppose we ever will, because it's out there now, probably the rest of our lives. But I think we're learning to live with it and the economic effects, the damage that has been done, that will linger for a long time. But it's dissipating. And that's translating into better earnings coming out now from companies and better prospects for the year ahead. And in that respect, Asia will be leading the world into recovery.

And I think the Biden approach, it won't change much. I would imagine the Biden administration will be much more thoughtful about tariffs. Most of the tariffs Trump imposed hurt American consumers much more than Chinese manufacturers. And I would think that he will look at that and say, where is it actually a win for the U.S.? And I would imagine, we'd see rollback of certain tariffs for low value-added items that don't have any strategic importance, that are sold in Walmart and Costco, to people who are on tight budgets. And that should lead to price reductions of certain consumer items in those channels over the next couple of years.

But I think generally, the American approach to China will not change substantially. Certainly in matters relating to national security, I would not expect to see any change. And in part, that's of course, because one of the few bipartisan consensus issues in American politics today — and there are sadly very few of those — is hostility to China. And this is a shame, really, but it is a fact that since Trump started his campaign for the presidency, five to six years ago, the attitude of the American public to China has gone from roughly 40% unfavorable to over 70% unfavorable. And so you can't really see any real change in security or other aspects of the Chinese-U.S. relationship.

And the Chinese, I think, have already come to that conclusion and that's why they have got this new policy for their five-year plan called "dual circulation," which is very much domestically focused and the international aspect of it is basically living without the U.S. to some extent — and the U.S. used to be, of course, China's dominant trading partner, and isn't anymore. It's becoming decreasingly important each year, whereas the regional partnership, which I mentioned earlier, well, that's now the largest single part of the Chinese economic circle.

In summary, I don't see any really important substantive changes. But I do think it will be a better relationship in terms of people trying to find some common ground and be less confrontational. And that's good, for both the U.S. and China, and indeed, everybody else.

TWST: And in terms of what investors should watch out for in the coming year in East Asia, are there any trends that you're noticing beyond what we've talked about?

Mr. Morton: I think there's going to be a dramatic change in the bond indices. And I'm an equity investor, so I'm not the best person to talk about this. But China is going to get bigger weightings in global bond indices, which is sensible, because it deserves that when you look at the numbers and the size of the bond market. China is going to make every effort to improve the quality of its bond market and make it more accessible to global investors. China is offering a very attractive real yield in renminbi, the official currency of China.

So the big issue, I think, for global investors is yes, we need to be in the bond market in China domestically. How do we think about the renminbi relative in particular to the U.S. dollar? And of course, what's happening there is quite interesting, because it was weak earlier this year when the virus was strong in China and not so much elsewhere, and then in the middle of the year, it's changed substantially. We've gone from RMB7.2 to RMB6.6, RMB6.5 to the dollar. And of course, this is a managed currency, so it is subject to political interference, if you will, and those are the things one has to think about.

Do you want renminbi exposure? You have to think about what does the Chinese government want in terms of its fix against other currencies and we have moved from a straight U.S. dollar fixing to a weighted currency basket, but it's still a managed currency.

So this is true, of course, for equity investors as well, whether you're investing domestically in Chinese markets or through Hong Kong. The Hong Kong dollar may be pegged to the U.S. dollar, but at the end of the day, those Chinese companies listed there will be reporting their earnings, cash flow and net asset value in an underlying currency that will be moving in the same way against the Hong Kong dollar as it does against the U.S. dollar, which recently has been a big plus. And that's one of the interesting things that we'll see in March, when the 2020 numbers are released.

We will see as things stand today, a very significant markup in balance sheet, particularly for those companies who have foreign currency liabilities, a significant increase in equity value, reported in Hong Kong dollars — anything from 7% onwards — and also in earnings per share, which will be translated in a different way than point-to-point balance sheets, but still showing some benefit against the currency in which its shares are traded. And I'm sure the market hasn't evaluated that and adjusted prices to reflect it. So that should be an interesting and positive surprise, I think, for analysts and investors in March next year.

But returning to the Chinese bond market, this is offering a nice real yield at a time when most of the world isn't. I saw some research recently: 71% of bonds now globally — government bonds — are negative real yields and quite a lot nominal, of course, are even negative. In China, you've got a strong currency at the moment. And I think the dual circulation policy of the fifth five-year plan is going to be generally positive for currency strength in China. That's consistent. A stronger currency is consistent with the policy objectives that they have announced for the next five years.

So you've got, I think, on balance, probably, a modest currency gain, if you own domestic Chinese bonds, plus real yield. So it's going to become more and more important for global investors in fixed income, and to a certain extent, equities. But it's the bond story, which is actually the bigger one.

And let me also add here, I know there's been lots of headlines recently about panic in the Chinese bond market. And there always is at this time of year. But if you actually look at the default numbers, they're basically the same as they were in 2019 and 2018. So really no change.

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What is changing a little is that, I think the first full default in China was about six years ago. It's becoming a better bond market, less just SOE — state-owned enterprise — companies, although there are still plenty. Don't get me wrong, you have to pick your spots. And it's also I think, a good thing that we get defaults, because otherwise it's just another manipulated market.

Investors do need to recognize this risk. Chinese bonds were a one-way street for a while, which wasn't the real world. So actually, if some of these companies go to the wall it means the economy is cleaning up and doing a better job of taking out companies that have misallocated capital.

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So not a free lunch, but it's hardly a disaster. I mean, the cumulative default rate on Chinese bonds is like 1.7%, which I think is quite a lot less than the U.S. And there are a lot of zombie companies in the U.S., which shouldn't be allowed to live. But because of the incredible amount of liquidity, you're getting extraordinarily bizarre, covenant-light financing at low rates, which really don't reflect the risk of those investments. So I think even on a risk spectrum, you've got much more balance than people think, although I would, of course, say that the Chinese political overlay is a risk factor, which is different and somewhat less predictable.

TWST: And do you want to highlight a company that you find interesting?

Mr. Morton: Well, there are two sectors in China right now absolutely nobody likes. And so I think that's the place one should be going if you're a contrarian. And as it happens, they fit our style very well.

You don't make money by following the crowd. You make money by positioning yourself elsewhere and waiting for the crowd to come to you. And so the two sectors, which we're spending quite a lot of time on at the moment, are banks and property.

"And the quality of the loan book is definitely improving; it was probably at its worst in about 2015, 2016. So we don't really know how many bad debts are in the system, but I think it's a lot better quality loan book than it was five years ago. "

And if we take banks first, banks globally and particularly in Europe have been just a terrible value trap for investors for many years, really, since the global financial crisis. America has obviously done a much better job cleaning up the banking system. But Europe has not done enough, partly because of central bank policies, which have really been very, very unhelpful for the banking industry, and don't look like they're going to change much.

But if you looked at the Chinese banking industry, yes it's a manipulated industry as well, and it's the big four banks — **ICBC**, **CCCB**, **Agricultural Bank** (HKG:1288) and **Bank of China**(HKG:3988) — they're all doing national service, as and when called upon. But the situation I think is significantly better. I would highlight a couple of factors in particular. First of all, return on equity and the capital ratios are pretty good, but return on equity is roughly 10% for the sector. There's a bit of variation around that. I think it's what, 2% or 3% in Europe, a bit more in the U.S., but banks in China are earning more than their cost of capital, which is important.

And the second thing is that although there's been a lot of questions raised — and legitimately raised — about the quality of the loan book, the NPL — non-performing loan — ratios have been moving up a bit. And the actual NPL coverage ratios are significantly higher than in most other parts of the world, 200% to 300%. So actually, given the NPL book, you can say, in a way, that coverage ratio is a sort of tacit admission that things aren't quite as they should be in the loan book.

However, this has been going on now for a number of years and the real coverage, therefore, is getting actually better. And the quality of the loan book is definitely improving; it was probably at its worst in about 2015, 2016. So we don't really know how many bad debts are in the system, but I think it's a lot better quality loan book than it was five years ago. Now, we haven't owned anything in this space, since about 2015, but we just got back in this year.

And talking about specific companies, the big four are all basically the same — it's kind of hard to differentiate between them. They're plodding along at a sort of low multiple, five times, seven times earnings maybe, discount to book and yielding 6%, 7%, with a little bit of growth — not much, low single-digit over the last five years, and probably the next. And so cheap, but not that attractive, really.

But elsewhere in the picture, I think we have a quality bank, the go-to-bank if you want the best in the business, is **China Merchants Bank** (SHA:600036). They've actually been achieving the highest growth rate of any listed bank in the last few years and projected to do well. I would say it's the best run bank in the country. They've got the best business mix. They were early into consumer lending. They've got the highest ratio of mortgage and retail exposure in their loan book of any of the larger listed banks.

Now, of course, this is not a secret and so this bank trades at the highest multiples in the sector. It deserves to and it's the safest bet. Its yield is actually quite low — 3% roughly — trades at a premium to book and a higher multiple of earnings. So it's not the bargain, but it's probably the better place to go if you just want to pick one and you want the large liquid stock that's a proxy for an industry that's coming out of the difficult time.

And this is a point I want to make, which is, in the first half of 2020, the Chinese banking regulator said to the banking industry, you know, you need to share the pain of your clients and essentially said, RMB1.5 trillion should be sort of a sacrifice of the industry relative to their profits. And that translated, if you looked at it across all the listed banks to the expectation that the earnings from the first half of 2020 would be down roughly 10% on the same period in 2019. And lo and behold, when you got to the half year results released in August, just about every large listed banks' earnings per share was roughly down 10% plus or minus a little — not all of them, but most of them.

1-Year Daily Chart of China Merchants Bank

Chart provided by www.BigCharts.com

But what's interesting is how they got there, because if you went up the income statement and looked at the profit pre provisions, actually, they were all up. So what was going on was that the industry wanted to comply with the guidance and deliver earnings that showed they were sharing the pain and so they actually took more provisions than usual and some of the banks even ended up changing their provisioning policy in order to get to the appropriate profit level.

So that's sort of slightly discouraging on one level, because you could argue that the earnings have been manipulated. But on the other hand, what happens next? So here we are in the second half of the year, and things are much better, default rates don't seem to be getting worse. In fact, I hear in terms of credit card defaults — they're very low at the moment, and much better than they were six months ago. So what do you do if you're a bank in the second half of the year? I think this is a challenge.

The regulator has sort of indicated they're much more relaxed now about this, so I imagine that you revert to prior policies, which suggests to me that you'll see earnings growth in the second half of the year, but even more interesting, what about the first half of next year? Overall, these banks that really struggled to deliver negative 10% growth will be facing a very low year-on-year comparison and also not so much provisioning required.

I don't know how this is going to play out, but I'm pretty confident we're going to see more earnings growth in this space over the next few periods than we have in the last five years. And I don't think the market has factored this in at all.

For us, actually, we have been buying something called **Chongqing Rural Commercial Bank** (SHA:601077). And that's a large, local bank. I think it's the second largest rural bank in China. And it's — as you could imagine from the name — centered in Chongqing, which is an important regional center in China. And interestingly enough, the Chongqing-Chengdu geographic area has just been identified as one — as the sort of fourth focused area of policy for the government. We have the Greater Bay Area, we have the Yangtze River Delta, we have the Beijing-Tianjin corridor, and now we've got the Chongqing-Chengdu conurbation, and so this is going to be an area that's going to get a lot of government support. So that's a good thing if you're a bank, particularly if you are the leading bank in the area — which they are — and they have a very low cost deposit base.

And because banks are so important in China, and they do do national service, and they are a conduit where policy is used by the central government to achieve objectives, I think you'll find they're going to be protected to a certain degree from what I call natural competition in the sense that fintech is going to be co-opted into the banking system to some extent and that's part of why **Ant Financial** had to suspend its IPO. There were other reasons, but that's one of them.

And then again, also digital currency, you know, the digital Yuan, which is being trialed by the top four banks will be China's answer to Bitcoin. You may know that a lot Bitcoin miners in Shanxi Province were basically closed down and China is taking a pretty dim view of some of these rogue cryptocurrencies. And digital Yuan will be, I think, rolled out through the banking system for the general population and my guess is cryptocurrencies will be illegal in China.

1-Year Daily Chart of Chongqing Rural Commercial Bank

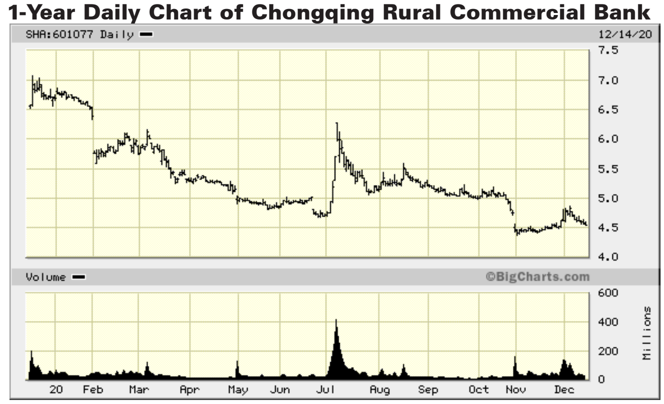

Chart provided by www.BigCharts.com

But turning back to **Chongqing Rural**, why do we like it? Well, it's trading at the lowest valuation multiples in its history, 0.3 to book and a forward earnings per share multiple for next year — kind of ignore 2020, because they've been manipulated. But looking forward, it's roughly 3 times price-to-earnings ratio, possibly less, and the yield likely to be 7% to 8%. That's a good trifecta of valuation multiples. Even more interesting is the bank is a bit behind some of the others and so it's got a lot of growth opportunities, which may not exist in some of the bigger banks.

We spoke to management recently and asked about their five-year plan for 2025 period. And their number-one target for improvement is digitization of services. So even though the cost-to-income ratio is really very low — running in the 25% to 28% range — they see opportunities there. They see opportunities in collateral services; they are still really just getting going in things like wealth management — asset management license they got last year to do investment management.

The banking service part of their businesses is still in its early days, and yet even so, this is a bank which has been growing faster than the industry — not quite as good as **China Merchants**, but pretty decent. And my guess is high-single-digit growth in the 8% to 10% range is sustainable for the next five years. And compared to a p/e of 3x, that looks good to me. So you've got this attractive package and in an area where the Chinese government is going to be very supportive because Chongqing-Chengdu is going to be a key focus for growth in the country.

So you've got an industry everyone dislikes, which all investors are underweight — CLSA says the most underweight ever for institutions, domestically even, certainly internationally — which you can buy at a bargain basement price with decent growth prospects and paying a high yield in a relatively strong currency.

And so they have a big issue and enormous amounts of debt. It's not really clear, but something like RMB120 billion of refinancing to do fairly soon and so that's a challenge and that's a stock I would be continuing to avoid. And there are others who may have problems — **Sunac** (HKG:1918), **R&F** (HKG:2777), **Greenland** (SHA:600606) — these are companies we've never owned because we've never liked the financial profile even though some of them have done quite well both in business terms and even in stock market terms, but in but in reality, we've been uncomfortable with the risk profile.

And these companies have all got a lot of work to do to get themselves back in the good graces of the politicians. But let's be clear, politicians don't want to kill the property industry; it's still extremely important. I mean, it's still the largest, by far, source of revenue for local governments. And so what they want is a healthy property industry. They don't want problems like — well, the U.S., had in 2008. They don't want some of the problems Korea had in the late 1990s, early 2000s, or Japan in the late 1980s.

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TWST: Any other companies that are that are notable?

Mr. Morton: Well, the other space I would look at is property. And property is really out of favor. I mean, it's never a loved sector for investors in China, but it's really out of favor at the moment because of the three red line policy, which hasn't actually been officially implemented yet, but probably will be in the first quarter of next year.

And for those who don't follow this stuff, the three red lines are basically tests relating to balance sheet and leverage to be applied to all property companies probably in China, but certainly the big listed ones that were laid out in a meeting in August with the Ministry of Housing and the People's Bank of China, and 12 of the leading property companies that attended to discuss these proposals. And if you pass these tests, you are green; if you fail one, you are yellow; if you fail two, you are orange; and if you fail three, you are red, and you really do not want to be red. Red essentially means that until you get back in compliance with these tests, you won't be allowed to increase your borrowing.

Actually, the industry is being given essentially 2.5 years to get in compliance, but in China, if you want to succeed in business, you have to kind of get ahead of the policies and be on side and so you want to show that you are trying to comply, you are doing something to comply sooner rather than later. But in practice before penalties are levied, you are supposed to have 2.5 years, which is quite a long time to fix any problems. And most do not have much of a problem. Still, some really do have, I think, a serious issue.

The one which has been getting all the publicity, of course, is **Evergrande** (HKG:3333), which is massively leveraged, and a very complicated company. I mean, we have never owned this company. I've never been able to understand what goes on inside it and I don't think anyone else does, either. All sorts of strange deals and business diversions and things, which may or may not be questionable — I have no idea. But in any case, if you can't analyze something properly, you shouldn't own it.

They've looked at these property models, and how the property market became skewed with inappropriate leverage and excessive valuations and are trying to prevent that happening in China, which is why they're acting now. But there are some very good quality companies within the sector, which because of this policy shock are now again trading at really silly valuations.

1-Year Daily Chart of Yuexiu Property Co Ltd.

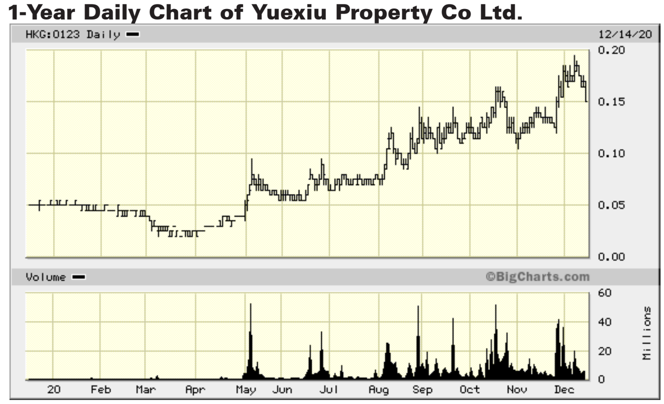

Chart provided by www.BigCharts.com

Take **Yuexiu** (HKG:0123). This is a company that had a bit of a checkered history. It's essentially majority owned by Guangzhou city government through a series of holding companies and in partnership with the MRT, and that's an important point. But this is a company which is an SOE — state-owned enterprise — but it's beginning to behave a bit more like a private company. And one of the great advantages of being an SOE is you don't have to worry too much about financing and indeed, 123 has an amazing model where they will take options on land banks to purchase with a small down payment and only actually have to pony up all the cash when they're ready to go.

And this of course is today the treatment which puts them in a really good position to buy and of course, with partnership in their main market, Guangzhou, although they're all over Guangdong. Guangzhou is the center and a great place to be if you're in the property business. They've got this partnership with the MRT, which is also their second-largest shareholder. And essentially, they're building out this model of development with new MRT stations, which is a mixed community, residential, office, retail, leisure, whatever, around the MRT stations, which of course is where a lot of people want to live.

China Resources Land (HKG:1109), who are probably the two best-run companies in the industry. **Vanke** (HKG:2202) is another good one, but they're priced reasonably, I think. There's some upside, but upside is finding companies that are not — understood by the investment community, and have something special to offer.

Times (HKG:1233), with their model of urban village redevelopment is another which I think is very interesting. **Powerlong** (HKG:1238) is probably the number three in commercial/retail integrated community development in China. **Dalian Wanda** and **China Resources Land** are the leaders, but **Powerlong** is the most interesting from a value proposition.

"They've looked at these property models, and how the property market became skewed with inappropriate leverage and excessive valuations and are trying to prevent that happening in China, which is why they're acting now."

So this is good margin backlog and it's already over 20% of their land bank. This is a model which worked very well, for example, in Thailand with **Supalai** (BKK:SPALI), which was an investment we had for many years in our main fund. But **Yuexiu** we think people don't understand it, because it's a company that lost its way. About seven, eight years ago, they had a chairman that I think was not doing a good job and diversified into other parts of China, all the way across the country up to Yantai of all places — about as far away as he could go. I mean, why this company was in Yantai is a mystery. They shouldn't have been there. They lost money there.

They are one of the powerhouses in Guangdong; they are the market leader in Guangzhou, the center of the Greater Bay Area, a key policy conurbation involving Hong Kong, Shengzhen all the way around to Macau and Zhuhai. It has been trading at around 6 times earnings — which is not especially cheap — but their growth trajectory is going to be way above sector average — mid-teens or more — for two to three years at least, and they will be able to maintain and possibly even grow their gross margin because of this high-quality land bank they've been able to get at a time when most companies in the sector will be seeing gross margins come down from the sort of high-20s to 30% down to the mid to low 20% to 25%. **Yuexiu** should be able to stay above 30%.

So I think this is a company which hasn't got much following in the market, partly because of its checkered history, partly because it's an SOE. It doesn't have much broker support, but people are going to start seeing the financial results as early as March next year.

And just to give you a preview, in October, for example, they had the highest growth rate in contract sales of any listed property company followed by Bloomberg, or indeed, by us. I know a month doesn't make a year, but they are way ahead of the pack this year in hitting their target for contract sales. And we expect this company to be a wonderful package of relatively high growth, improving margin and strong sustainable dividend growth in the next three to five years with a yield over 7% next year, whereas some in the industry will be marking time.

Plus, one other thing, they've made a move into eldercare, which will be a differentiating factor. And I mean, this is the point in a way: You've got 200 listed developers you can choose from. Most of them you should stay away from. You've got **Longfor** (HKG:0960) and

And then you've got **Yuzhou** (HKG:1628), which started its life in Xiamen, which is a very important city and is now focused on the Yangtze River Delta. And they are trading at a ridiculously low multiple — 3.5 times earnings — double-digit yield, discount to net asset value, marked to market of their land bank, and investment property portfolio of around 70-plus percent. The chairman is a very good land buyer. He's very astute.

1-Year Daily Chart of Powerlong Real Estate Holdings

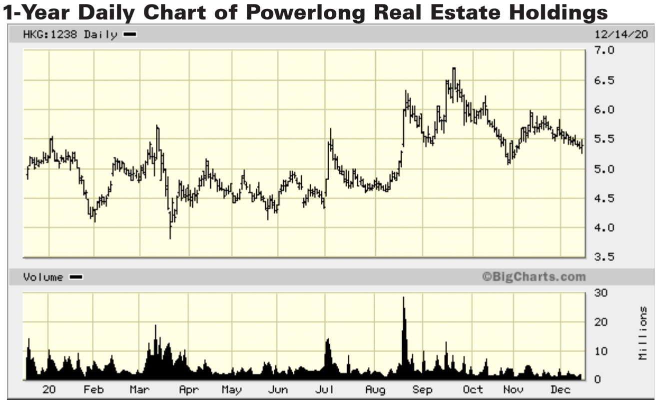

Chart provided by www.BigCharts.com

None of the companies we own are red, or indeed orange. You don't want to own those. Yellow is OK, because it's pretty easy to fix; green, obviously, better. But really, there's been a sort of panic reaction in the market with the whole sector sold off about 20% because of partly **Evergrande** — its well-publicized and real issues — but most of the sector actually doesn't have the same problem. And in fact, companies like **KWG** (HKG:1813) and **CIFI** (HKG:0884) have been refinancing their bonds since the red lines were widely known at lower interest rates, which tells you, I think, that people who are following this closely are quite comfortable with exposure. So we've got several of these names in our portfolio now and we think they're going to reward us very well in the next couple of years.

TWST: And looking ahead to 2021, why would investors want to make sure that within their portfolios there is some exposure to China and other parts of East Asia? Why is this a good year to look at that area to find stocks?

Mr. Morton: Well, just as a general observation, I would say that the world is massively under-weight China anyway, and has been, and that's been a good call actually, because America markets have obviously been the best place to be for a long time particularly in tech. And of course, this year, 2020, has been even more so because tech has been the only space with a little bit of healthcare that has benefited from all the problems caused by COVID-19. And some of the things that will happen this year, I think, are just an acceleration of trends that already existed, but bringing them forward at dramatic speed.

The Wall Street Journal the other day said that in six months we've seen 10 years of movement. And that's not going to reverse. I mean, a little bit maybe, but people's behaviors have changed. On the other hand, a lot of growth in these sectors has been telescoped and brought forward into a short timeframe, so one wonders if a lot of the, what I call, more established technology companies are going to find growth a bit more difficult to come by going forward.

Now, coming back to your question: Why China? China, apart from the fact that the domestic markets do, in fact, contain a lot of tech; the valuations there are somewhat, I'd say, uncomfortable as they are in other parts of the world for these stocks. Not as bad as in 2015 when we had a bubble, but the rest of the sectors, both Shanghai and Hong Kong markets, are cheap. Cheap in an absolute sense, cheap in a relative sense to their history, cheap relative to other parts of the world and cheap relative most important, perhaps, of all, to the growth that they should be getting.

And Chinese companies, they're back in business pretty much. You look at anything from retail sales, to transport, to even domestic flights, they're all back showing year-on-year growth. You can see it in the power generation numbers. And these are statistics you can trust and it's happening.

So earnings growth is going to be really easy next year, particularly in the first half. And I don't think on the whole, markets have factored this in fully. It's going to be a lot easier to find earnings growth in China than in some other parts of the world where the economies are still, I'm afraid, under siege.

And then apart from anything else, the Regional Comprehensive Economic Partnership is going to have an impact on trade in this region. And not just China; you'll see more Chinese investments in Vietnam and Indonesia, which will help those countries and the companies in those countries. So yes, underweight China is a poor decision, I think, at the moment and most of the world, and particularly European and U.S. investors are way underweight, and many don't have any exposure at all. Yet this is the largest growing economy in the world. And that will be reflected in the earnings growth of the companies which I think you'll see rerated.

TWST: Is there anything we haven't talked about you care to bring up?

Mr. Morton: Well, I would only say that the search for income is just the biggest single challenge, I think, in the investment industry today as the world's population ages. Of course, China is an aging society too. Japan, Korea, all of Northern Asia — it's not just a Western or European problem.

This search for income is — it's going to be one that the investment industry needs to solve, whether we're talking through REITs, which I think are a useful retirement product — although we don't own many in our portfolios, because they don't tend to have a lot of growth unless you've got a very active management team doing asset enhancement. But they're useful products and China is going to be launching C-REITs, supposedly this month, although I haven't seen any yet. That's going to be a massive new market.

But I think if you could find companies that can grow — which is what we do — that can grow their earnings, their cash flow, earnings per share, at a decent rate, not particularly ambitious, but high-single-digit, low-teens, consistently over time and throw off excess cash, you can come up with a portfolio that is going to deliver decent value growth as the business value increases each year, but also throws off cash to shareholders; and these companies do meet this challenge.

And with the disruption we've had — particularly in Europe, but also countries like Australia, less so in the U.S. — to dividend payments, you want to be looking for income in countries that are more reliable and pay dividends more consistently. And that's been a marked feature of the Hong Kong market this year. Practically every company we monitor has delivered. Less than 5% of businesses cut back on dividends in our universe.

So I think if you're looking for income, this is the place you should be looking. And I know, traditionally, Asia has been considered the place to go for growth, and it still will be in some way relatively the growing part of the world, but also increasingly the right place to look for income.

TWST: Thank you. (ES)

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