NIPUN CAPITAL, L.P.

China A:
Right Here, Right Now

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The structural and economic case for investing in China including strong GDP growth, the opportunities created by urbanization, and the rise of the Chinese middle class is clear. In this note we go deeper, and focus on the more tactical issue of timing. Our conclusion is that for many institutional investors, current conditions are ideal for securing a greater portfolio exposure to Chinese domestic equity markets. We will discuss the sizing of this exposure and the fit with a broader Emerging Markets portfolio in a follow up note.

Our summary observations are:

- The Chinese A share market is the second largest in the world. It is also the most under-owned equity market.

- This is set to change with MSCI including Chinese A shares in its flagship MSCI Emerging Markets Index. We estimate that $1.2T will get invested in Chinese A shares over the next few years. This wave of foreign flow into Chinese A shares will further propel the market, which is already cheap compared to historical levels.

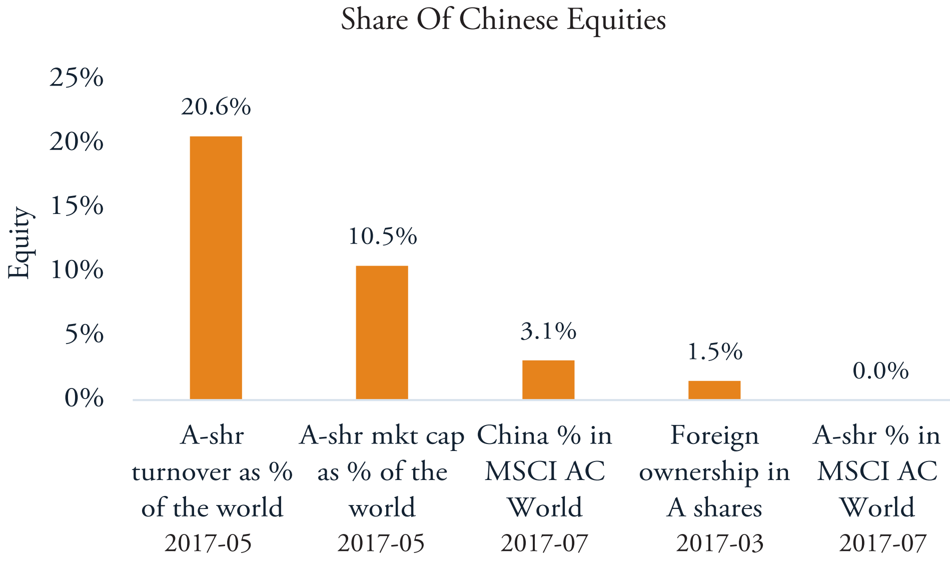
- This market represents huge untapped potential for active managers. The market is relatively inefficient, stock level dispersion is high and valuation spreads are wide.

- We believe that government intervention, if any, is likely to be aimed at stabilizing the market, thereby providing downside protection. Early investors in Chinese A shares could earn significant rewards.

China is too big to ignore

The Chinese A share market is the second largest equity market in the world with a market cap of $7.8T.[1] It is also one of the most liquid markets in the world, accounting for over 20% of the world equity market turnover.

Chinese equities are dramatically underrepresented in institutional portfolios



Source: FactSet, MSCI, Goldman Sachs Global Investment Research

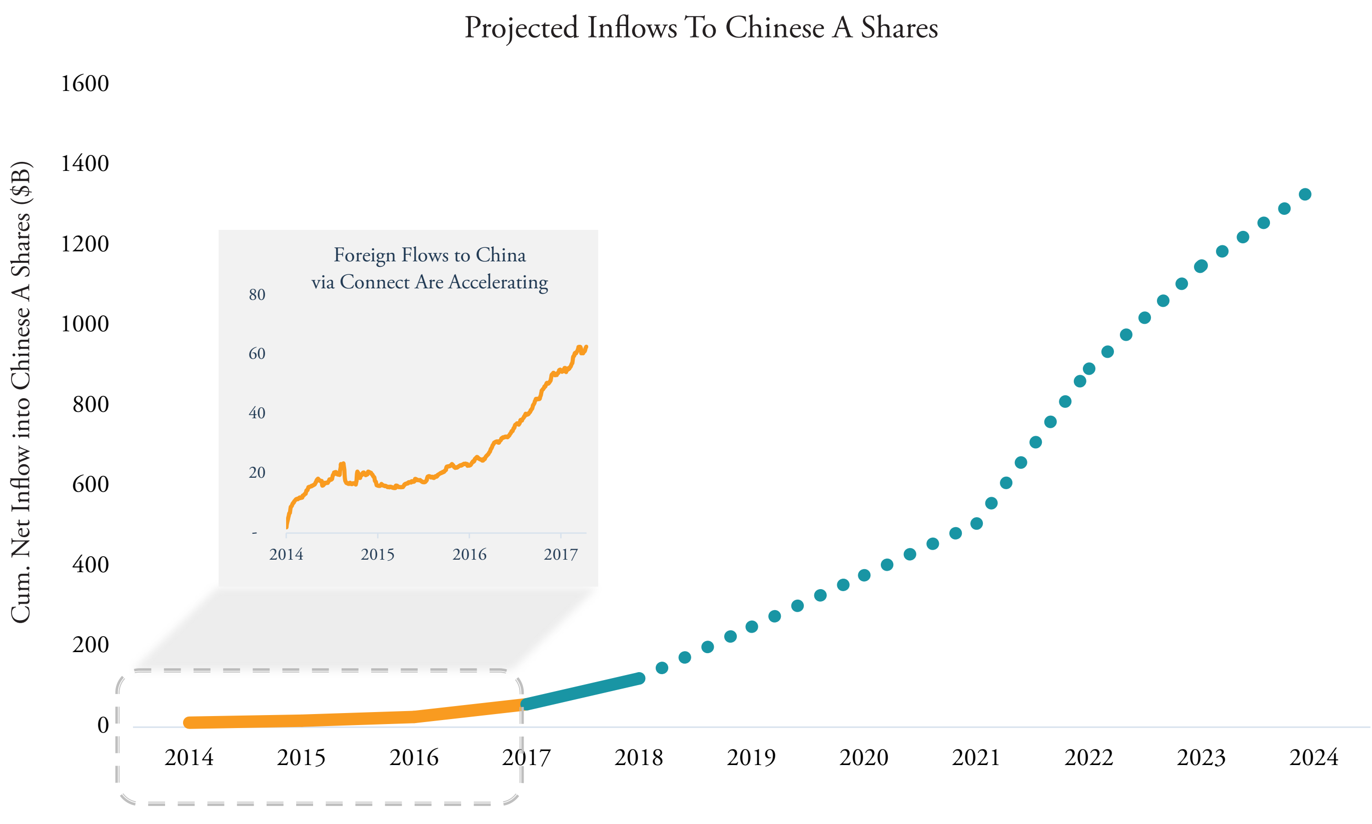
Nevertheless, it is one of the most underrepresented markets in institutional investors' portfolios, mainly due to legacy reasons. In the past, it was difficult for foreign investors to freely access this market. However, this has changed with the establishment and growth of the HK-Connect program, which allows foreign investors to access Shanghai and Shenzhen listed exchanges via Hong Kong.

[1]Source: Bloomberg as of February 28, 2018.

Foreign investor flows provide a huge impetus for Chinese equities

The upcoming inclusion of Chinese A share equities in the MSCI EM Index offers a huge impetus for Chinese equities. MSCI is including Chinese A shares in its Emerging Markets Index at a nominal weight starting May 2018. China has been "on the bench" for inclusion for several years but finally the overwhelming institutional demand and the change in access mechanisms enabled MSCI to add it to the Index. We project that over $400B will flow into Chinese equities over the next 5-7 years from passive investors alone. Even at the high end, passive mandates would only represent 30% of all flows.[2] Hence, we extrapolate that the total flow into Chinese equities (including active mandates) could be as much as $1.2T over the next few years. We believe this flow will provide significant support for Chinese stocks.

Foreign investors could invest over $1.2T in Chinese equities over the next five to seven years



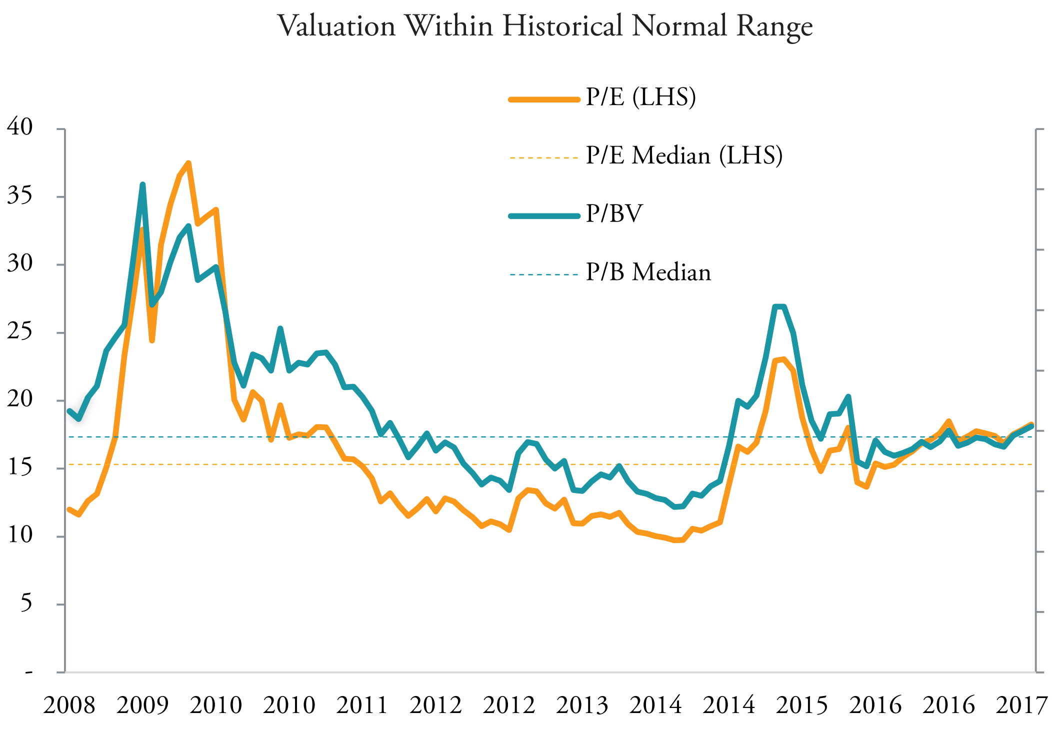
Source: Nipun Internal Analysis. *Assumes that passive flows in line with inclusion factors of 5% in 2018, 15% in 2019, 25% in 2020, 35% in 2021, 65% in 2022, 85% in 2023 and 100% in 2024. In addition, assumes that non-passive flow stay at 2017 level of $32B. Assumes that active flows is twice as much as passive flow.

[2]Passive share outside the U.S. ranges from 5 - 15%. Hence, one third is very conservative estimate.

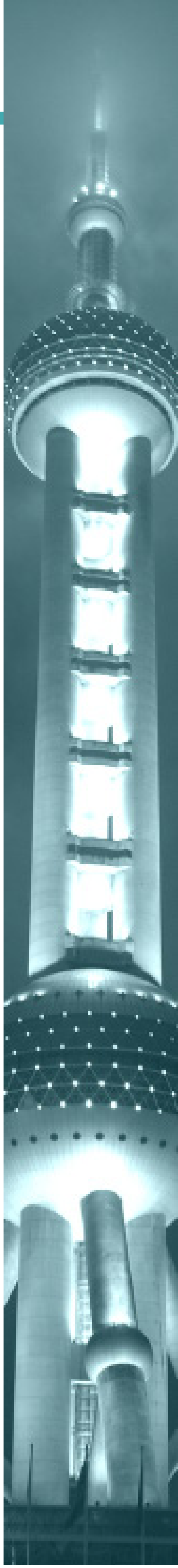
Chinese A shares are currently undervalued

Over the last 10 years, the Chinese exchanges and authorities have taken significant steps to build on the reform agenda initiated in 2006, improve accessibility to the markets, institute governance and remove barriers like the capital gains tax. It is remarkable that despite these significant changes, there has been no change in the multiple that the market is awarding to these stocks. The market is still trading at its Median P/E and Median P/B of the last 10 years. Yes, new issues have emerged, such as the debt problem, but nevertheless Chinese equities trade cheap (or at least are not expensive) compared to their own history. They are also cheaper than Chinese real estate, which is the only other significant asset class that the Chinese retail investor has access to.

Chinese equities have not been rerated for 10 years



Source: MSCI, Nipun Internal Analysis



Chinese A shares offer one of the largest alpha opportunities in equity markets

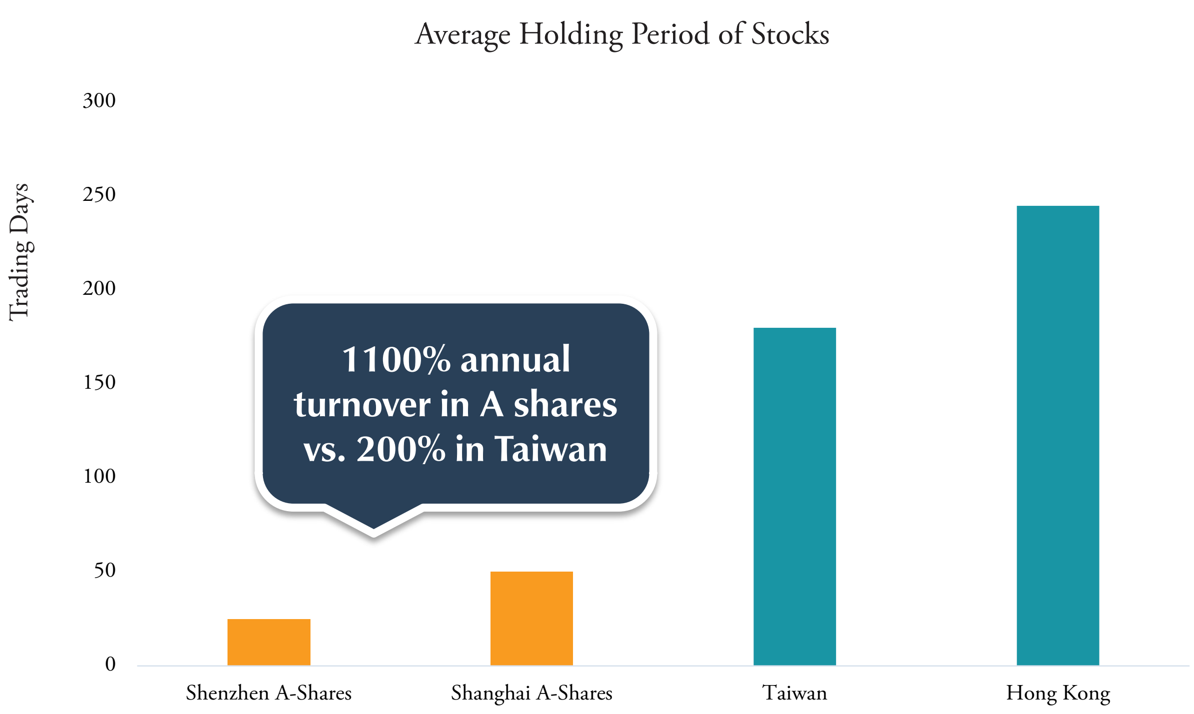
The alpha opportunity in China is substantial as it is a relatively inefficient market. To analyze this, we use the classic definition of market inefficiency where the current prices do not reflect all the publicly available demand and supply information.

In China:

- There are significant barriers to information collection and synthesis. Data is often reported in local language across a multitude of regulatory bodies. Analyst coverage of stocks is low with almost one-third of stocks having minimal analyst coverage (one or less analyst covering the stock). All this makes it harder for investors to quickly synthesize data and trade on it, resulting in an opportunity.

- Retail participants dominate trading in the Chinese A share market, often taking levered positions with high levels of turnover. They are most susceptible to behavioral biases, thereby driving stock prices away from fundamentals and creating opportunities for disciplined active managers.

Chinese investors trade a lot without regard to fundamentals



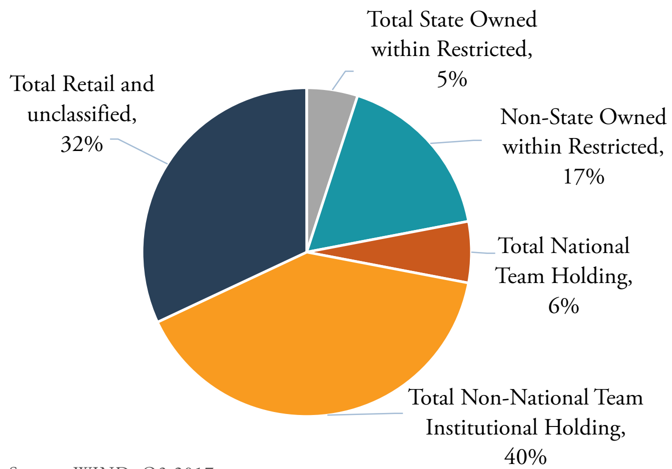
Source: Nipun Internal Analysis. Based on data from 2015.

Chinese A shares offer one of the largest alpha opportunities in equity markets (cont.)

There are substantial holdings by investors who may be holding stocks for reasons other than returns and are often restricted from freely trading their stock. For example, in mid-2015 when the Shanghai and Shenzhen equity markets posted huge losses, Chinese regulators deployed capital in the stock market through a set of state-owned financial institutions collectively known as the "National Team."[3] Market analysts believe that the National Team is still nursing paper losses from that intervention. We believe that these investors inhibit price discovery and add to market inefficiency.

Significant holdings for non-economic reasons

China A-Share Total Market Capital By Investor Type

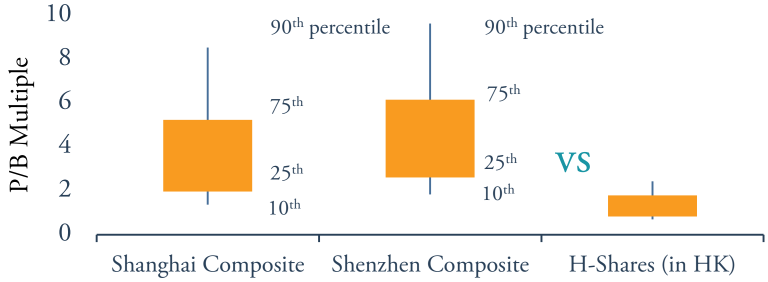


Source: WIND, Q3 2017.

The investor behavior in this market is ultimately reflected in the wide valuation spread. The valuation spread within Shanghai and Shenzhen listed stocks is over three times the spread of HK listed stocks. In essence, this represents the alpha opportunity in Chinese equities.

Strong opportunity for active management

Wide Spread In Trading Multiples



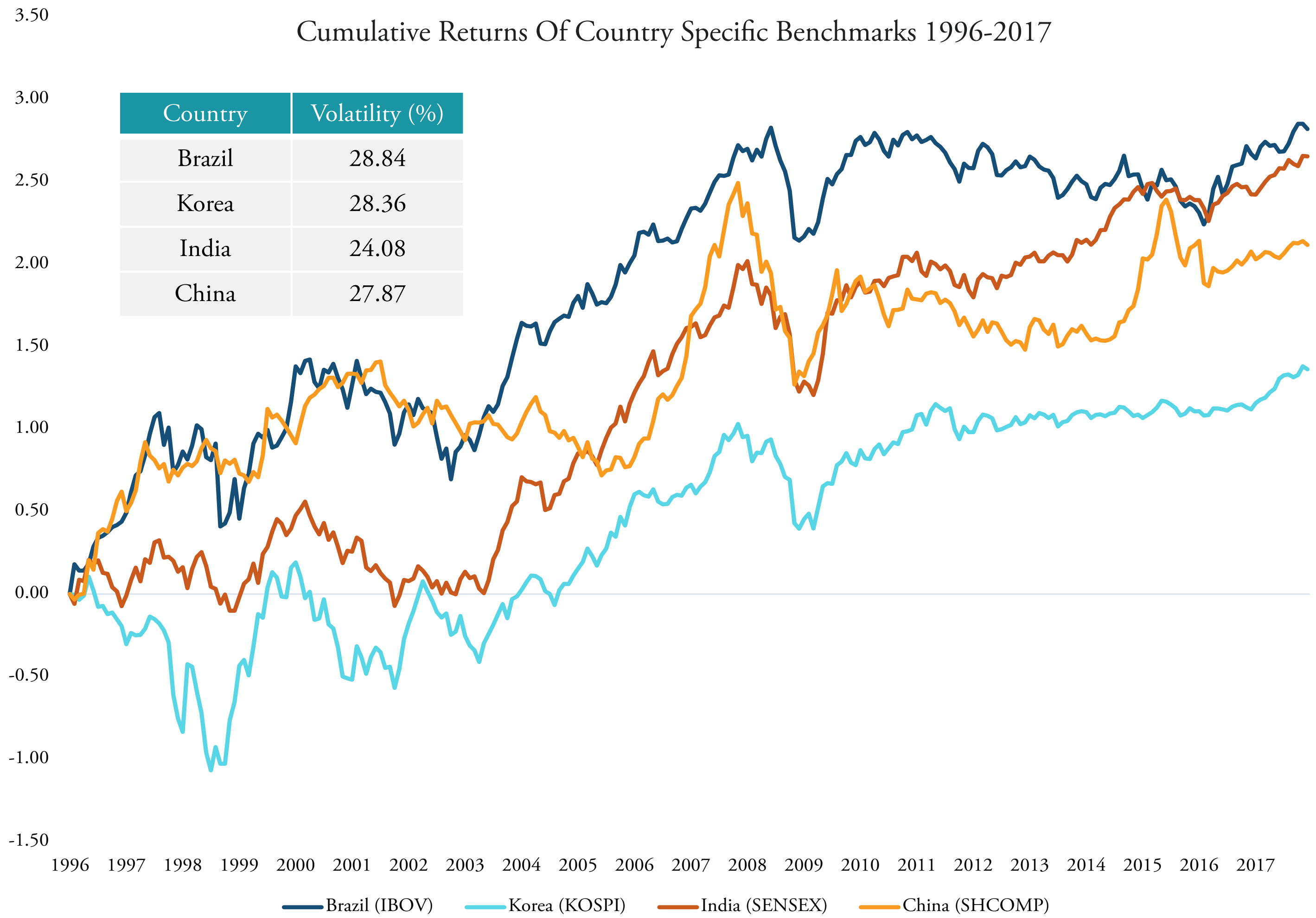
Source: Nipun Internal Analysis. Bloomberg, as of September 30, 2017. Spreads are calculated using the average of the 10th, 25th, 75th and 90th percentile of Price to Book ratios of the Shanghai, Shenzhen and Hong Kong HSCEI composite constituents.

[3]The 'National Team' includes state entities (Central Huijin, Huijin AM, CSF, Buttonwood, Fengshan and Kunteng) and 10 funds invested by these entities.

The risk of investing in China is overstated

While the headlines are dominated by the risks of investing in Chinese equities, the data shows that equity market volatility in China is no different than that of other emerging countries like Brazil, India or even Korea, which incidentally is classified as a developed market by the FTSE.

Chinese equity volatility similar to other emerging markets



Country	Volatility (%)
Brazil	28.84
Korea	28.36
India	24.08
China	27.87

Source: Nipun Internal Analysis, Bloomberg

The risk of investing in China is overstated (cont.)

Investing in single country mandates is inherently riskier than investing in a broader global mandate. However, in the broader portfolio context, adding an allocation to China A reduces the volatility of an EM portfolio. Specifically, the predicted total risk of the MSCI EM benchmark as of the end of February 2018 was 15.38%. Adding a 10% allocation to China A would reduce this total risk to 15.11%. This is driven by the relatively low correlation between China and other EM markets.

China A shares diversify your EM allocation

Equity Market Return Correlations*

	China	Japan	Asia Ex-Japan	S&P	MSCI World	MSCI EM	Average
China	1.00	0.39	0.51	0.40	0.45	0.50	**0.45**
Japan	0.39	1.00	0.61	0.63	0.71	0.59	0.58
Asia Ex-Japan	0.51	0.61	1.00	0.76	0.88	0.97	0.75
S&P	0.40	0.63	0.76	1.00	0.95	0.74	0.70
MSCI World	0.45	0.59	0.88	0.95	1.00	0.87	0.75
MSCI EM	0.50	0.59	0.97	0.74	0.87	1.00	0.73

* Correlations are based on monthly returns from Feb 2010 to Jan 2018. China refers to MSCI China A International Index, Japan refers to MSCI Japan, Asia Ex-Japan refers to the MSCI Asia Ex-Japan Index.
Source: Nipun Internal Analysis, Bloomberg

We often hear is that government intervention is the biggest risk of investing in China. While this may be true, it is important to understand the government's current incentives. The Chinese authorities understand that market volatility has deterred foreign investors and relative stability in their market is one of their top priorities, in order to both protect domestic investors and induce foreign inflows.

China aims to be an economic superpower and they know that foreign investment in the equity markets will be vital to this aspiration. They waited several years to be included in the MSCI indices and are addressing all the concerns that MSCI has raised regarding investability, scalability and access. They understand that a substantial intervention would significantly change the prospects and timeline of their inclusion in the world indices.

That said, the Chinese government is unique in that it can manage equity market volatility without a visible intervention. For example, early in February 2018 when equity markets took a significant dip, there were reports that the Shanghai Stock Exchange encouraged major shareholders to boost holdings. More than 110 companies listed in Shanghai and Shenzhen released statements related to major shareholders boosting their stakes from February 9 through February 12.[4] These actions may be classified as government intervention, but ultimately we believe such actions support the market and are beneficial to long only investors in China.

[4]Source: Bloomberg

ONE COMMON CONCERN: "CHINESE STATE OWNED ENTERPRISES ARE NOT INVESTABLE..."

Nipun has been investing in Chinese A shares for nearly three years. We evaluate over 1,800 stocks in China and often trade State Owned Enterprises (SOEs). We are sometimes asked why we invest in Chinese SOEs, as foreign investors often question the legitimacy and objectives these entities. SOEs are perceived to have poor management and to be operated for socialistic objectives.

We believe that these views are over-generalized. There is substantial differentiation amongst Chinese SOEs. More importantly, our research shows that SOE stocks respond to similar factors as stocks of non-state owned companies. For example, earnings surprises drive returns for most equities around the world. This fact holds true in China too, for SOEs and non-SOE stocks. We believe this is largely because the market structure and investor behaviors in China that create inefficiency in the pricing of stocks operate irrespective of whether the company is state owned or non-state owned.

Conclusion

Some of the concerns regarding investing in Chinese equities are valid but most are overdone and are preventing investors from gaining access to one of the largest and most inefficient markets in the world.

We believe that Chinese equities offer significant return potential. If China A were to be fully represented in the MSCI benchmark today, it would comprise 17% of the benchmark. To be conservative, we recommend that investors start with investing 20% of their EM exposure in Chinese A shares. If you would like more detail on this, please look out for our next note coming out in a few weeks.

In our opinion, access to the Chinese market represents a landmark event in the history of global equity investing. We believe the long term impact of China's inclusion in broad equity markets is severely underestimated. Being ahead of this trend is likely to serve you well.

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