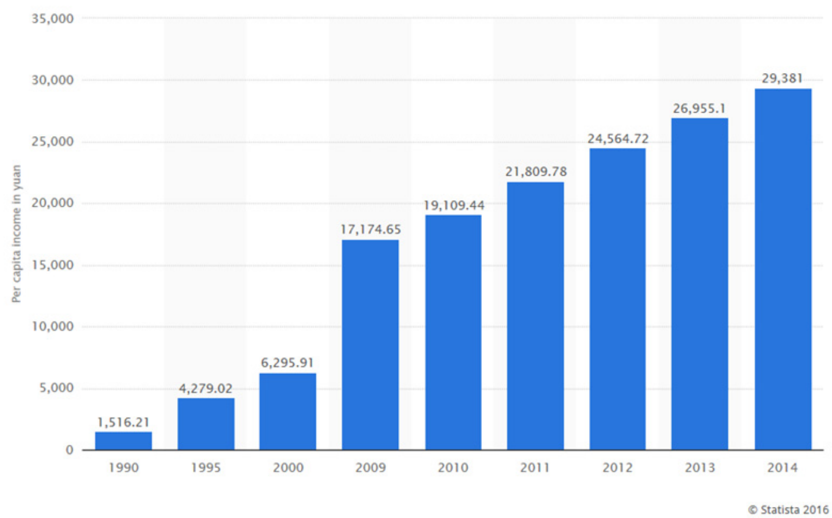
COMMENTARY

January 29, 2016

Dear clients and colleagues,

No one knows for sure if China's GDP will grow 6.5% this year. No one knows for sure what 6.5% growth means either. But what is certain is that China's growth picture remains two-sided. The services sector has been, and will continue to be, a strong driver of GDP growth. In 2015 the services sector grew by 8.3% and accounted for half of China's GDP. Consumption continued to be robust supported by solid wage growth.

Annual per capita income of urban households in China (in Yuan)



Our portfolio is constructed around investment themes that benefit from long-term secular growth trends, such as consumer products, innovation, environment, demographics, and outsourcing. In the case of China, the focus is clearly on consumer products which have benefited from the rising middle class.

We invest in H shares, not A shares. We invest in non-state-owned enterprises with high insider ownership. We invest in global companies that have a diversified source of revenue, not just from China. For example, there are three Hong Kong-listed companies in the Global Small Cap portfolio. Their revenue contributions from China are about 10%, 15% and 49%.

Vitasoy International derives 49% of its sales from China. It has been a holding in our portfolio since inception in August 2008. Keeping a long investment horizon has paid off. The stock price is up 275% since August 2008, compared to -11% for Hang Seng Index. Founded in 1940, Vitasoy is known as the "Soy Expert". Its soy milk products are sold in over 40 countries, and it is the market leader in China, Hong Kong, Australia and Singapore. The founding family still owns 63% of the company and is actively involved in operations. It has excellent environmental, social and governance (ESG) practices and has won numerous awards including Outstanding Corporate Social Responsibility by Quamnet and Best Investor Relations Company (Hong Kong) by Corporate Governance Asia. Superior product quality and a consistent growth strategy helped sales to grow 14% during April – September 2015, driven by 32% sales growth in China.

Our exposure to China also comes from holdings listed in other developed markets that usually derive less than 20% of their sales from China. For example, a few Japanese companies with leading global market share in their niche provide high-end machines and parts to automotive and smartphone manufacturers in China. Savills, a leading global real estate services provider based in UK, conducts services in China ranging from transactional, consultancy, and property management to funds management.

Last week, a top holding (Treasury Wine Estates) reported strong sales growth. It is a leading global wine producer based in Australia, with 10% of sales from Asia. Its portfolio includes global brands such as Beringer, Penfolds, Wolf Blass, Lindeman's, Rosemount and many other regional brands. The company's growth strategy to accelerate the high-end wine market is working well. In its latest results, sales in Asia grew 46%. Recent shipments to Asia were particularly strong ahead of Chinese New Year.

Although not a big wine producer, China was ranked fifth in world wine consumption in 2014, and first in the red wine category. According to economists at the University of Adelaide's Wine Economics Research Centre, the huge growth in Chinese wine consumption will transform the global wine industry. They project that China's wine consumption will grow by between 40% and 60% from 2011 to 2018, helped by China's recent bilateral trade agreements with Australia, Chile and New Zealand.

We remain confident about the resilience of Chinese consumers. Notwithstanding the extreme volatility in the A-share market, there are no signs of a sharp deterioration in fundamentals. We expect the Chinese government will soon roll out measures to achieve a slower but sustainable GDP growth, including more liquidity injections, more interest rate cuts, more reserve-requirement ratio cuts and expansionary fiscal policy.

Have a nice weekend.

The Global Alpha Team