HIGHLAND

EMERGING MARKETS: OPPORTUNITIES IN ASIA

Emerging markets have long been a key investment in our clients' portfolios. With their growing importance in the global economy, the companies domiciled in the countries provide interesting opportunities for investors. Specifically, China and Asia as a whole have been key focus areas for us. In light of the growing opportunity set and the recent trade discussions between the U.S. and China, we recently sent our head of alternative strategies, Jason Copeland, CFA, CAIA, to Asia to further assess the investment landscape in emerging markets. The trip included visits to China, Hong Kong, and Singapore. Over the course of a week, Jason conducted 32 meetings with managers in both the public and private space. While near term prospects are dampened by the impact of the coronavirus, we feel that long-term growth opportunities are ripe for investors. The following is a Q&A with Jason detailing many of his findings:

Q: *What type of returns should investors expect in China as its economic growth slows down?*

A: If we think about how we view the world, three things drive returns: cash flow, growth of cash flow, and the change in multiple you will pay for it. In China, GDP growth has been around 6% and earnings growth has historically been about one to three times that level. Before the coronavirus, earnings growth was expected to accelerate back into the double digits. If you look at the earnings yield (i.e., the inverse of the price-to-earnings multiple, the higher the number the cheaper the valuation), it is high single digits. At the end of the year, the P/E multiple was in the low teens, much cheaper than the U.S. P/E of 24.

With higher earnings growth than we have in the U.S. and twice the earnings yield, the expectation is that you should earn more in China despite slowing growth. The trade-off with these investments is that they have historically much higher volatility and less consistency of return versus their U.S. counterparts.

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TRANSFORMING PORTFOLIOS. ADVANCING MISSIONS.

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Regarding other major asset classes in China, I don't believe you receive the return premium you need to go overseas in traditional fixed income or real estate. With a 3% yield on China's 10-year government debt and similar investment grade spreads to those of U.S. companies, core bonds are not compelling.

Real estate valuations, such as capitalization rates, in tier 1 cities are similar to what we have in the U.S., and Net Operating Income (NOI) growth (excluding industrial) has been slower and probably will be for the foreseeable future. Real estate is a big piece of the economy, and real estate and most old economy businesses don't offer very promising return profiles.

Our recommendation is that if you want to invest in China, public and private equity offer more upside. Active management is definitely a must. The alpha opportunity is much greater there than it is in the developed world. Some of these markets are largely driven by retail investors. China A-shares, for example, is still 3/4 retail investors, and many other markets have a much smaller institutional presence than what we typically observe in developed markets. Also, many of these markets are less transparent, and there is still meaningful value that can be gained from real due diligence and information relative to buying the index. Asia ex-Japan is approximately 2/3 of the allocation in an emerging market (EM) index and 6% or 7% of global equities. That doesn't sound like a lot, but within the benchmark it continues to grow in importance. If an investor has more than four or five equity managers in their portfolio, considering an allocation to Asian emerging markets could make sense.

Q: *If you were investing in China, can you talk through the prospects of public versus private markets? Where is there more opportunity and how would you compare the different risks of each?*

A: Sure, I think either could potentially be interesting, but transparency is paramount. Having a higher standard when it comes to diligence is important in China, as companies commit fraud in both public and private markets more frequently than we generally see in the developed world. So many managers in China crowd into the same names and believe there is safety in numbers. Of the large public frauds that have been exposed in recent years, a number of managers have been on the wrong side of it. Allocating to a manager that goes above and beyond in research is a key trait. Also finding managers that are local and knowledgeable about the inner workings of the Chinese government is extremely important. I think a number of long/short managers that have long-only funds are well suited for this because many are trained to independently verify data, check channels, and view the world with a healthy degree of skepticism.

Most of the notable private companies in recent years have been venture capital firms. Of the 500 unicorns in the world (i.e., private companies with a valuation greater than $1 billion), China is home to 200 of those companies. Today, it is getting more competitive in some areas, and similar to the U.S. some prices are quite high for venture companies. Growth equity is perhaps a little more interesting, but also becoming a more mature landscape. The buyout market is new but growing, and few have a real track record here. Having said that, there could be some interesting opportunities (such as companies in the industrial sector) here in the not too distant future.

As for public equities, the A-share market is still highly inefficient, and until somewhat recently, it was incredibly difficult to short stocks. With that said, it is not the only way to invest in China. ADR's provide another vehicle for investors to purchase stock in Chinese companies listed on U.S. exchanges.

China has about 18% share of the world's GDP, and it is growing faster than the vast majority of countries. If their capital markets and index weights continue to grow, the result is that incrementally more dollars flow into China and ultimately the overall region relative to the developed world. With more money flowing into passive and indices, it certainly doesn't take a rocket scientist to see how the tailwind could be meaningful.

Q: *Are there a lot of differences between investment strategies that focus in Asia ex-Japan or China?*

A: Some larger firms have teams that invest in both, but I would say that it really comes down to culture and diversification across the growth life cycle of some of these countries. Japan and South Korea are certainly the most developed. China is still emerging, but they have made substantial progress toward becoming a developed nation in the past two decades. Because of higher wages in China, much of the world's cheap labor is now being outsourced to Vietnam, Indonesia, and other places across the Pacific Rim. If India started down the same trajectory that China did two decades ago, it could be the best growth story of the next 50 years, but this may come into question in light of their infrastructure, politics, culture, and a myriad of other reasons. However, India's GDP per capita is where China's was 15 years ago, and they have more than 15% of the world's population. So, it deserves some attention, despite being a small piece of emerging and global equity markets.

Q: *How do authorities see investors that short Chinese securities? Is it more difficult in practice to offer a hedged strategy than in other western markets?*

A: That is a great question. Had you asked me that three or four years ago, the answer may have been completely different. Despite the temporary ban on short selling due to the coronavirus, China appears to be warming to the prospect of shorting securities. There are actually a few onshore investment banks with prime brokerage desks that do a good job of sourcing borrowed shares to short many of the companies listed in China. These A-share shorts have been notoriously hard to borrow, but it is getting easier. However, it still isn't cheap. H-shares or Hong Kong–listed Chinese companies have been notably easier to short.

Q: *How does China continue to make their capital markets system more open to foreign capital without disrupting the current banking system?*

A: China has spoken for years about being friendly to foreign investment, but until recently, it has been more talk than action. The financial system still has high barriers to entry, but in October, they announced that foreign firms for the first time would be allowed to establish insurance companies on the mainland. They even discussed the possibility that foreign lenders could establish wholly owned banks in China, but to my knowledge, there is no definitive timeline for this proposal to come to fruition. This could absolutely attract foreign direct investment. However, it could potentially impair the government's ability to plan and control the growth of their economy as they have in the past.

Q: *China's banking sector is massive as a percent of its economy (over 300% of GDP). How does China cope with any type of downturn that leads to banks taking losses?*

A: That is definitely a multifaceted question, and I believe that number may include some shadow banking estimates. The banking sector is one of the largest in the world, approximately $14 trillion, just slightly larger than the U.K. and marginally smaller than the U.S. banking system from an asset perspective. Unlike the U.K. and U.S., the top five banks control more than two-thirds of the assets. Four of these are the "big four" state-owned enterprise banks (SOE), and the fifth is China Bank of Construction, which is majority controlled by the government. When needed, these banks can help support the mandate of the Central Government and provide credit to areas that align with central planning. Historically, that has been incredibly effective.

Arguably the shadow banking system that has developed in recent years has presented challenges to this model. The size of the shadow banking market has grown materially, with estimates as high as $11 trillion. The parts of that market that have gotten the most attention are the levered investment trusts that promise double-digit yields to investors. Some of these have gone bust in recent years. The 800-pound gorilla in this space is Ant Financial. This company is majority owned and controlled by Alibaba and handles more than $14 trillion

in payment volume annually. For reference, that is more than either Visa or Mastercard processes collectively.

The Wall Street Journal recently stated China's nonperforming loans (NPLs) totaled $895 billion as of September 30, 2018. The recent trade war has taken a toll on growth, which has slowed to its lowest level in about 30 years. Having said that, the entire banking system is bolstered by meaningfully higher reserve requirements in China than here in the U.S. Early last year, China reduced its reserve requirements by 1% to help encourage lending. If things were to worsen, they could be more accommodative. However, the data from China has been improving, but we will have to wait and see how the coronavirus could impact that.

Q: *China has recently seen its first few defaults of corporate bonds in the past year. Is this going to be a more normal occurrence and does this lead to more opportunity in distressed type investments?*

A: Yes, we believe there will be opportunities in distressed investments. There are a few notable distressed investors in China today. We met with one in Hong Kong recently. Corporate bankruptcy process is still relatively new in China, despite having a legal framework in place for a decade. Historically, failing companies were taken over by state-owned enterprises, but from the anecdotal stories I have heard, this has resulted in less than stellar outcomes for traditional creditors that expect to be paid back in full. In many cases debt holders have a worse outcome than they would generally expect in western courts, as equity survives more of this process than one would expect under U.S. court systems.

These days SOEs are selling some portion of the troubled asset to third parties and rely on asset managers to manage the workout. This allows the banks to keep some skin in the game should the loan become profitable. This is different from the process in the U.S., where banks sell the entire loan to a third party. In light of the unique structure and bankruptcy laws that are more equity friendly, at the right price and with the right situation, even these investments can offer an attractive return.

Q: *How does China continue to execute on its Made in 2025 plan in the current market in which its biggest export partners (U.S., Germany, Japan, South Korea) see China's rise as adversarial?*

A: They should see it as adversarial, as should anyone who derives much of their GDP from selling cars, pharmaceuticals, or technology to China. Not only for lost revenue, but for the future competitors. If you think about what is really happening with the trade war, I think technology is at the heart of it. The key issues at hand are intellectual property rights and better protection for our resilient services-based economy, which is incrementally being driven more and more by technology companies. You mention Germany, and many of their largest companies are automotive or tied closely to that industry. Samsung, which is responsible for almost 20% of South Korea's GDP, should be worried about Huawei and Xiaomi and their growing dominance. Japan has historically been a leader in tech, and likely has plenty of reasons to worry.

It appears U.S. technology companies may be hit the hardest as a result of the Made in 2025 plan. It was recently announced in the press that China has mandated that all government offices phase out all U.S. technology over the next three years. Who do you think that impacts the most? Microsoft and Adobe for software, Google for phone operating systems, and dozens of other U.S. companies for the semiconductors that go into these machines.

Q: *What opportunities have you most excited? Most concerned?*

A: The growth of China's economy is strong, and the growth of those businesses emphasized in Made in China 2025 are even stronger. Not only are many technology, consumer, and healthcare businesses experiencing phenomenal revenue and earnings growth, but most also have a substantially more attractive valuation than similar U.S.-based companies. I think there are names in these areas that could be the best compounders over the next decade.

If you could go back in time 10 years and invest in Facebook, Amazon, or Netflix, would you? Sitting in the U.S. has provided us an incredibly unique perspective. As the seat of innovation for the world, things tend to happen here first. China may no longer be 5 or 10 years behind, but an argument could be made that there are counterparts to many U.S. technology powerhouses in China, only earlier in their investible life. In some areas these companies have even better adoption or addressable markets, because they don't have the same legacy issues we may have. Over the past decade, the best place to be invested has been the U.S. However, that wasn't so for the previous decade, and it may not be in the coming decade. So, investments in Asia could be a diversifier, but if you plan on making a direct investment, you should do so with the expectation that they will also be a return driver.

Aside from the impact of the virus that will likely hurt in 2020, the area that scares me the most, and likely dampens the outlook for China altogether, is in the real estate market. Prices are high, cap rates are low, and excluding industrial properties, NOI growth is low or in some cases negative. The commercial market isn't great, and retail tenants are struggling even more today with concerns about contagion. The prospects for the residential market are not much better.

Real estate is a huge driver of growth in China. In many tier 1 cities such as Hong Kong, Shanghai, and Beijing, home prices have risen over fourfold. The sustainability of those prices is something to watch. The government has always supported the real estate market, but that could change. Investors should be wary that the returns of the past are fading, and stagnant prices could diminish returns going forward. I think equity (both public and private) offers better return potential.

Q: *Jason, you were in Hong Kong during a period of historical political unrest. How did that experience impact you personally?*

A: I think there were two things I observed that were the most impactful. First, it shocked me how far people were willing to go to get what they wanted and felt was a right. Second, it certainly made me think more about some of the personal liberties we have in the U.S. that we sometimes take for granted. Hong Kong, a city where the cost of living and the population with real wealth is analogous to New York, has historically enjoyed many more civil liberties than those on the mainland. However, free speech to the extent we have it and the right to elect all their officials is still something that they don't have. There is still censorship to some extent, especially when people are speaking negatively of the central government. The top leader in Hong Kong is still appointed by the Central Government.

What I witnessed was not a peaceful demonstration, from my perspective, but more violent and excessive. In the central district, people were destroying sidewalks and lining the roads with the bricks from the sidewalks. It was even worse in some areas with shops, roads, lights, and train stations being destroyed. Students in universities were barricading entrances, setting fire to things, and shooting arrows at those attempting to enter. While I didn't go anywhere near the universities, the front page of the morning paper looked like a scene out of Mad Max one day when I was there. To make matters worse, people on the mainland don't sympathize with those in Hong Kong, partially because Hong Kong citizens enjoy more freedom than those on the mainland and many civilians from the mainland were getting badly beaten or hit with bricks by locals just for traveling to Hong Kong.

Ultimately, you want to sympathize with them because they are fighting for the freedoms that we have, but doing it by destroying commercial and public property and hurting innocent people is hard to comprehend. Despite what you believe or who you support politically, it makes you feel lucky to live in a country like the U.S.

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