Federated Hermes Limited

Why investors should take another look at China (through a contrarian lens)

Generating alpha in a dynamic and volatile market

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Investors have been pessimistic on the prospects for Chinese shares of late. However, with attractive valuations currently on offer, the China Equity team believe a unique opportunity has presented itself.

Key points:

- Chinese equities have begun to rise from multi-decade lows, perhaps presenting an attractive entry point with potential for long-term outperformance.
- The multi-year sell-off has created an abundance of opportunities across a wide range of attractively-valued companies.
- Our approach is well-suited for a dynamic and volatile market which provides opportunities to generate alpha by exploiting market inefficiencies and stock mispricing.

After sustained weakness, Chinese equities may have begun a sustainable rebound off multi-decade lows, with the Hang Seng Index rising about 25% from its January trough[1]. As Chinese equities pause following a strong run, we believe they hold the potential for compelling returns.

China is the world's second-largest economy, produces one third of the world's manufacturing capacity, contributes 19% of global GDP,[2] and accounts for 17%[3] of all listed companies, yet its stock market remains at the same level it was a decade ago[4].

Chinese companies include established 'old economy' entities, and newer businesses in nascent emerging industries such as solar and electric vehicles. Many are seeking to move up the value chain. Last year, Chinese companies achieved positive earnings growth, yet the stock market continued to derate on persistent negative sentiment[5]. This year, earnings are expected to continue growing[6]. While macroeconomic conditions remain volatile, a property market bottoming may be in sight. We believe the combination of these factors may help confidence.

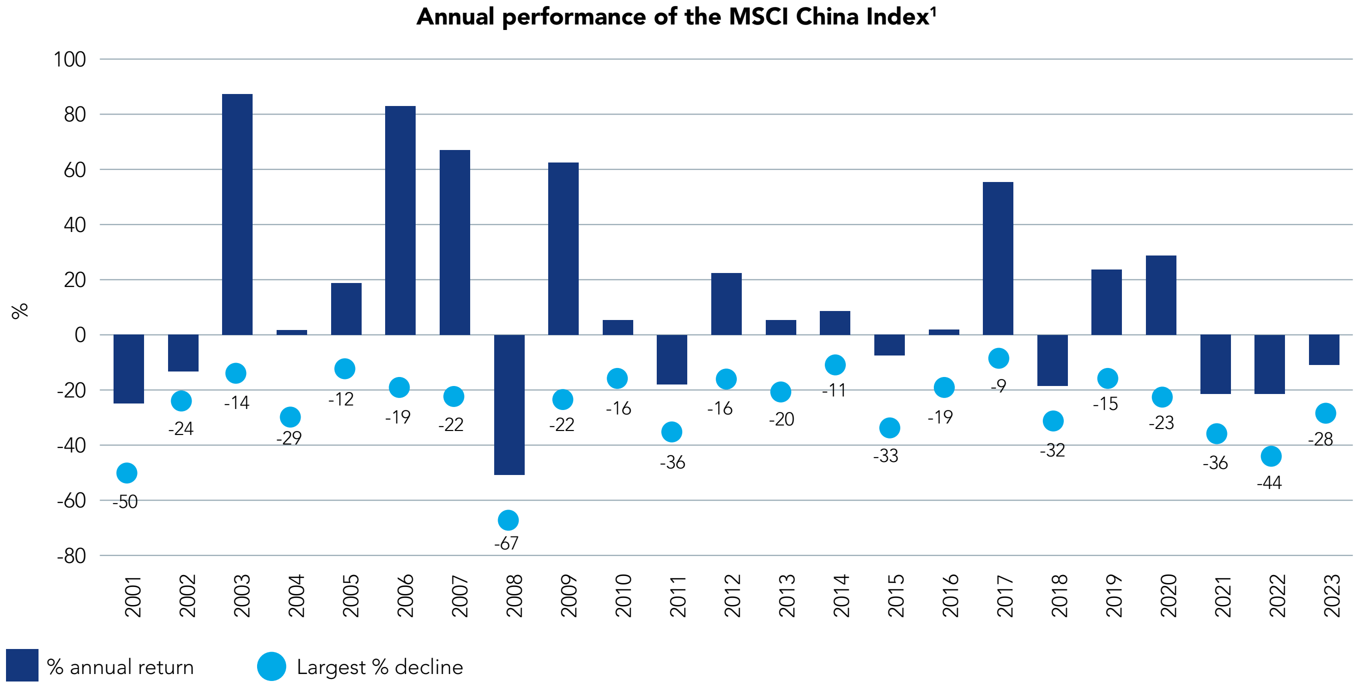
A contrarian opportunity

We find the current opportunity set to be particularly compelling. Following a prolonged sell-off, valuations are attractive among both high and low-quality stocks.

Historically, Chinese equities have been volatile – over the last 23 years, there have been 14 bear markets[7] – but, as contrarian investors, we believe volatility can present attractive investment opportunities. Valuations and a focus on price remain crucial for generating alpha in a volatile market.

[1] Bloomberg, as at 12 July 2024.
[2] World Economics, as at 2023.
[3] Goldman Sachs, as at 30 April 2024.
[4] Bloomberg as at July 2024.
[5] Bloomberg, as at July 2024.
[6] Ibid.
[7] A bear market is defined by a prolonged drop in investment prices – generally, a bear market happens when a broad market index falls by 20% or more from its most recent high.

Figure 1: Annual index returns vs. annual drawdowns – Investors pay a high price for being 'shaken out'



[1] MSCI China Index used to show longer return history.

Source: Bloomberg, as of 31 December 2023.

The China Equity team draws on its experience of running the Asia ex-Japan Equity Strategy, which, since inception, has had almost half of its allocation invested in China. We have not historically needed market tailwinds in order to create alpha – rather, we look for bottom-up opportunities. Looking at the performance of the Asia ex-Japan Strategy since its inception in 2010[8], the China allocation has yielded an *annualised* return of 6.3%, while the benchmark China allocation has returned 1.8% over the same period[9]. The Federated Hermes China Equity Strategy was launched in July 2022 and has delivered a net annualised return of -2.8% since its inception, outperforming its benchmark on an annualised basis by 5.2%[10].

The information shown is supplemental to the GIPS® compliant composite report provided at the bottom of the page. Full performance of the strategy can be viewed at the bottom of the page. Past performance is not a reliable indicator of future performance.

Alpha generators

We invest in companies that are trading at cheap valuations relative to their earnings and long-term growth potential. We also seek arbitrage opportunities and 'special situations'.

For example, we examine inconsistencies between dual-listed A-shares listed in mainland China and H-shares listed in Hong Kong.

Our contrarian style means that we seek to identify companies that are mispriced or undervalued – either due to short-term challenges, or that have simply been overlooked. We favour companies that have attractive valuations, strong balance sheets and are supported by an attractive dividend yield or a well thought out buy-back programme.

We are happy to hold companies that we assess to be mispriced and will patiently wait, often collecting a dividend while we do. At present, there is no shortage of such companies. Chinese equities at the index level currently offer investors an aggregate dividend yield of approximately 3%, 15% forecast earnings growth, a price-to-earnings (P/E) multiple of 9x, all while benefitting from a benign inflationary environment[11].

Take Brilliance China for example, joint owner of BMW China. Brilliance has a large portion of its market cap in cash, and is paying it out in the form of frequent large special dividends, leaving its core operations attractively priced.

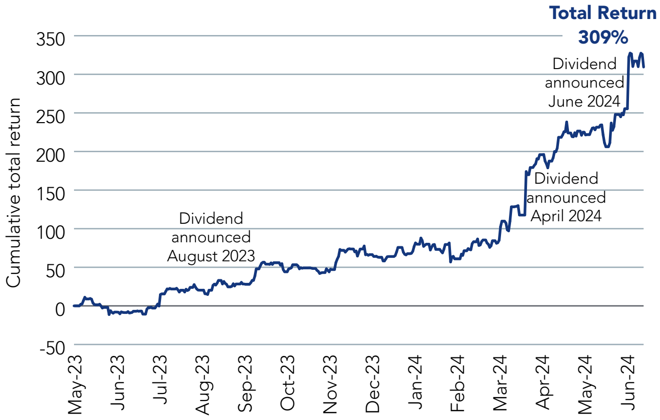
[8] Strategy inception 1 January 2010. Due to a change in data provider, attribution data is only available from 1 June 2010.This will have the effect of understating the performance shown for the strategy.

[9] Source: NT, Federated Hermes as at 30 June 2024. Geometric performance attribution, in USD, gross of fees. The information shown is supplemental to the GIPS® compliant composite report provided in the Appendix.

[10] Source: NT, Federated Hermes as at 30 June 2024. Annualised return in USD, net of fees. Relative return calculated arithmetically. The information shown is supplemental to the GIPS® compliant composite report provided at the bottom of the page.

[11] Bloomberg, as at July 2024. Price to earnings and dividend yield calculated as forward estimates.

Figure 2: Brilliance China Automotive total return (including dividends)



Source: Bloomberg, as at June 2024. Bought company in the China Equity portfolio on 3 May 2023. Sold 28th June 2024. Gross total return including dividends between dates is 309%.

We are contrarian rather than value investors, and seek opportunities irrespective of the underlying quality of the company. We typically need to look 'further afield' for such opportunities and tend to find our best ideas in areas of the market where others are not looking. However, given the cheapness of the market as a whole, a wide range of high-profile names are also attractively priced. For example, Tencent – perhaps the highest-quality company in China – is now trading on a valuation of 15x forward earnings[12], and paying healthy dividends while buying back shares.

While Nvidia dominates the headlines in developed markets – understandably given its exceptional growth – we believe there are overlooked growth companies in China that directly benefit from such growth (other than TSMC). One such example is Foxconn Industrial Internet, a leading provider of intelligent manufacturing integration solutions. Foxconn is a participant in the Chinese AI server supply chain and a beneficiary of robust market demand given its role as a key supplier to Nvidia.

Figure 3: Foxconn Industrial Internet: Price-to-earnings multiple & Price

Source: Bloomberg, as at July 2024. Stock bought in the China Equity portfolio on 25th July 2022. Position is still held within the portfolio.

Indirect exposure

We currently have no banks or property developers in our portfolio, and many of our holdings have substantial and growing businesses outside of China that help mitigate against currency risk.

For example, we own a US-listed Hong Kong wealth management brokerage that provides a similar level of market beta, but with a cleaner balance sheet. Instead of owning direct property plays, we currently own other proxy companies that provide cyclical macro exposure – such as, cement stocks. But with a far stronger balance sheet than the property companies. We also own other cyclical stocks with similar drivers that are correlated to the property market, such as Haier Smart Home, a consumer appliance manufacturer, that also generates half of its business outside of China.

A unique opportunity

While China continues to face headwinds, the current risk and reward trade-off remains a very attractive proposition for investors with yield providing a floor. There is also significant upside for investors against longer-term based valuations, as well as a potential re-rating to a normal multiple of Chinese equities, while the transition and global expansion into higher value-add manufacturing, such as solar and electric vehicles, also offers an attractive proposition. Overall, we believe that Chinese equities represent a fertile hunting ground for contrarian investors and – in light of the remarkably attractive valuations on offer – we are optimistic that investors should enjoy pleasing prospective performance over any reasonable long-term horizon.

To find out more about China Equity, please click here.

Investments in emerging markets tend to be more volatile than those in mature markets and the value of an investment can move sharply down or up.

The above does not represent all of the securities held in the portfolio and it should not be assumed that the above securities were or will be profitable. This information does not constitute a solicitation or offer to any person to buy or sell any related securities or financial instruments.

[12] Bloomberg, as at July 2024. Price to earnings and dividend yield calculated as forward estimates.

Rolling year performance (%)

	30/06/2023 – 30/06/2024	30/06/2022 – 30/06/2023	30/06/2021 – 30/06/2022	30/06/2020 – 30/06/2021	30/06/2019 – 30/06/2020
Strategy	1.67				
Strategy Net	0.91				

Source: Federated Hermes as at 30 June 2024. Performance shown is the Federated Hermes China Equity Strategy in US$, gross and net of fees using close of business prices. Benchmark: MSCI China All Shares Index. **Past performance is not a reliable indicator of future returns.**

Schedule of Rates of Return and Statistics

Composite **Federated Hermes China Equity**
Index **MSCI China All Shares Net**
Periods Ending **30-Jun-24**

	Returns (%)		
	Composite Gross Return	Benchmark	Composite Net Return
Q2 24	6.44	3.36	6.24
YTD	5.60	2.28	5.20
1 Year	1.67	(4.39)	0.91
Aug-22 – Jun-24 (Annlzd)^^	(2.10)	(8.00)	(2.84)

^^Represents composite inception period. See page 2 for additional notes to the schedule of rates of return and statistics.

The composite includes all discretionary portfolios following the China Equity strategy run by the Federated Hermes Asia ex Japan Equity team (London Office) and has an inception date of 1 August 2022. The objective of the strategy is to achieve long term capital appreciation. The benchmark is the MSCI China All Shares (net) index, which is designed to measure the equity market performance of China and covers all large and mid-market capitalization securities. The benchmark is market-cap weighted and rebalanced on a quarterly basis. The return is calculated on a total return basis net of withholding tax. This composite was created in August 2022. Performance shown for 2022 is for a partial period starting 1 August 2022. Federated Hermes claims compliance with the Global Investment Performance Standards ("GIPS®") and has prepared and presented this report in compliance with the GIPS® standards. Federated Hermes has been independently verified for the period of January 1, 1992, through March 31, 2024. The verification report is available upon request. A firm that claims compliance with the GIPS® standards must establish policies and procedures for complying with all the applicable requirements of the GIPS® standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS® standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report. The management fee schedule for this strategy is 0.75% per annum. Gross of fees returns have been calculated gross of management/custodial fees and net of reclaimable withholding taxes, but after all trading commissions.

Schedule of Rates of Return and Statistics

Composite **Federated Hermes China Equity**
Index **MSCI China All Shares Net**
Periods Ending **30-Jun-24**

Year	Composite Gross Return	Composite Net Return	Benchmark Return	*Composite 3-Yr Std Dev	*Benchmark 3-Yr Std Dev	Number of Portfolios	**Dispersion	Composite Assets (mil)	Firm Assets (bil)
2022	(1.70)	(2.01)	(5.81)	N/A	N/A	<5	N/A	26.8	627.4
2023	(7.51)	(8.21)	(11.53)	N/A	N/A	<5	N/A	5.0	720.0

*Represents the 3-year annualized standard deviation for both the gross composite and the index returns. Statistic is used to measure the volatility of composite returns.

**Standard deviation is calculated using gross returns. Standard deviation is not applicable (N/A) for any period if fewer than five accounts are in the composite for that period. (See footnote 5)

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Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns and, where possible, to contribute to positive outcomes that benefit the wider world.

Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by five decades of experience
- **Private markets:** private equity, private credit, real estate, infrastructure and natural capital
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

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