Buy China A Shares (CAF)

Report Date: 15-Dec-2018

From a recent news story:

"China's USD denominated High Yield Total Return Index is down -14.88% YTD. This is the second worst year since 2006. The average price of Bonds in the Index is at 88.95 while the RMB Denominated Bond Index average price is 88.39 indicating capital losses for investors. Value Partners, a Hong Kong-based money manager, identified 100 U.S. dollar bonds of non-state-owned Chinese enterprises trading at yields of 13% or higher. Most are scheduled to mature within the next two years."

Name one hedge fund manager bullish on China.

Kyle Bass is bearish. Mark Hart was bearish and probably still is. Everyone is expecting a sudden devaluation. China is going to run out of dollar reserves, yada yada yada.

Nobody has anything good to say about China, not even the leader of the free world.

With Xi being named dictator for life, nobody trusts the communist regime. "Made in China" means poor quality cheap stuff even to Indians.

Except for Jim Rogers, I don't know anyone bullish on China!

It wasn't that long ago that Chinese equities were hot. Every hedge fund had to own Tenecent, Alibaba, and other Chinese equities. The market might have been in a bubble but… you just had to participate and forget about valuations. Even if the guy pictured above was a typical representative of the Chinese retail participant.

I'll let Raoul Pal do the talking. In his GMI July 2015 issue, he took the bull case for China head on, and was he right!

Excerpted from Global Macro Investor (July 2015)

"I have no really strong view on Chinese equities. We know they are a bubble. We know that it looks strikingly like the late 1920s US. We know that the debt situation is a mess. We know that growth is imploding. We know that the PBOC have had to cut rates to prop up the banks. So why the hell does everyone own Chinese equities?

Because Louis Gave from Gavekal told them to. Louis' story of the institutional underweight of Chinese equities being the biggest risk to portfolios in the world is compelling and, based on a potential inclusion in MSCI indices – which is in turn based on the potential SDR inclusion – was just the story everyone needed to buy Chinese stocks. It justified getting involved in a bubble to tack on a bit of performance. I really like Louis and I think he is a smart guy but he is peddling China funds and a Chinese research service. I like the story but I think it is based on too many "ifs". I sincerely doubt that MSCI would add China to anywhere near full weight anytime soon. A shares just don't qualify. And I also think that the most popular future series from MSCI will likely be MSCI Asia ex-China, much like it was MSCI ex-Japan for the last two decades. China is really untradeable for most and speculative at best. I think the whole underweight story does not stack up.

Now, could Louis be right? Sure. Should we be involved considering everything we know about China? No. Definitely not.

Excuses, excuses…

Some of you have found a separate excuse to buy China and that is based on Chinese Internet plays. Again, anyone thinking that this is the justification of buying into the large speculative bubble in history is being naïve. No country has ever had this much of their market cap based on margin accounts. No country has ever had this much margin debt as a percentage of GDP. No country has ever had this much retail money piling in. No country has ever seen their stock market cap rise by $4trn in a year. The baseline groupthink assumption is that the government won't let the market fall. The faith in the Chinese Government is extraordinary. I'll stick to what I know. This is a bubble and bubbles burst. This is not a market to be long of, regardless of the reason.

This is what a crash looks like…

Can it recover and bounce? Sure. I'd leave this trade well alone. There are much higher quality trades out there."

This is the sequel to that story.

SHANGHAI SE COMPOSITE INDEX

(Shanghai Stock Exchange:SHCOMP)

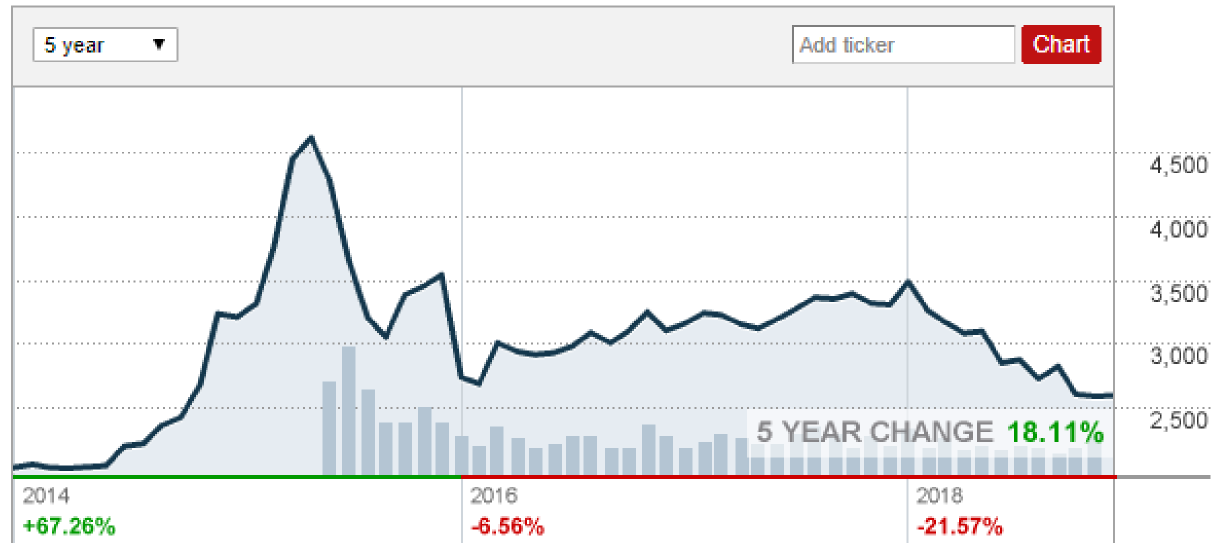
Add to Watch List | Set Alert

2,593.74
Delayed Data
As of Dec 14

-40.31 / -1.53%
Today's Change

TODAY
2,449 — 3,587
52-Week Range

-21.57%
Year-to-Date



Quote Details

Previous close	2,634.05	Today's volume	145,942,488
Open	2,627.28	Average daily volume (3 months)	14,285,435,326
Day high	2,629.16	Average P/E	--
Day low	2,593.74	1 year change	-21.22%

Data as of 2:29am ET, 12/14/2018

After peaking at 5178 on 12-Jun-15, the index has shed half of its value. Was there a bubble? Sure. Has it fully burst? I think not. China is a difficult market to get money in and out, more so than India. It is easier to be short the CNY or HKD than China A-shares, which means the mispricing will not correct due to market forces that easily. The PBoC has colluded with the brokerage houses to stem the bubble bursting, but as the chart shows, the bubble has been bursting nevertheless.

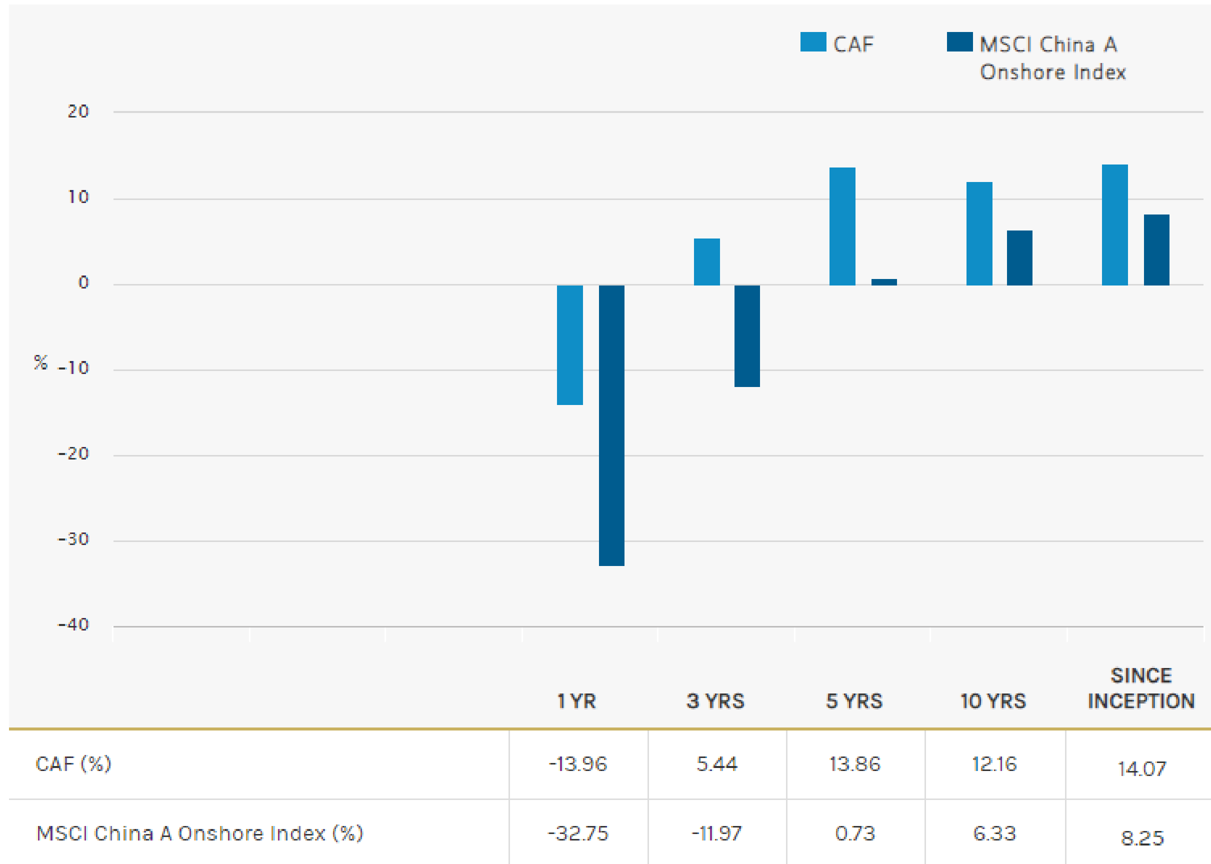
From this data alone, it is hard to make a bullish case for Chinese equities. Unless I pick individual names as Jim Rogers did in his book *A Bull in China,* I can't make a compelling argument for just buying the index – i.e. for making a bet that the Chinese growth story will pick up and drive equities across the board higher. Fortunately, I don't have to.

Average Annual Total Returns (NAV)

As of 10/31/2018

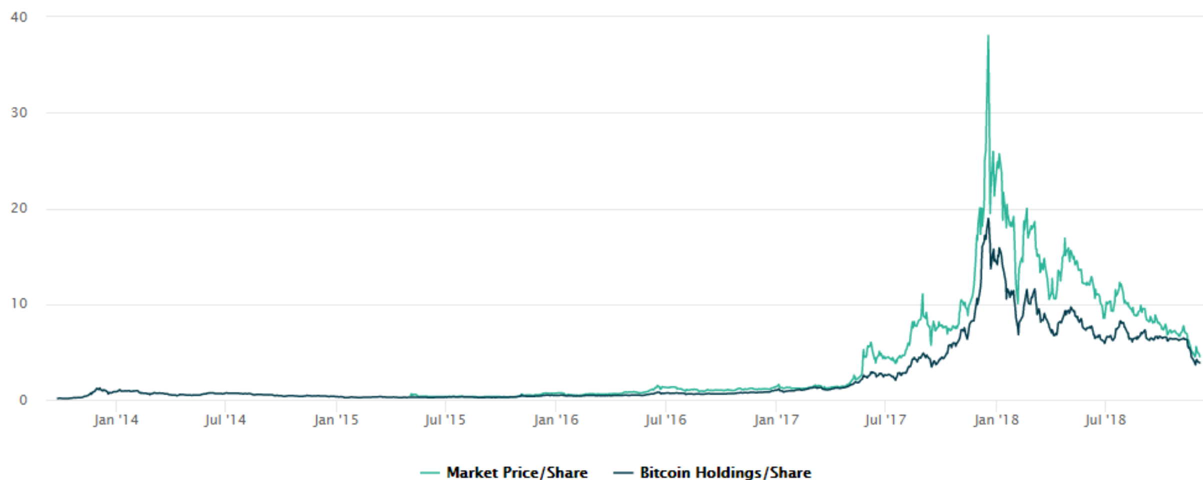
TIMEFRAME:

Month-end Quarter-end Calendar Year



	1 YR	3 YRS	5 YRS	10 YRS	SINCE INCEPTION
CAF (%)	-13.96	5.44	13.86	12.16	14.07
MSCI China A Onshore Index (%)	-32.75	-11.97	0.73	6.33	8.25

I want to own the closed-end ETF CAF. As the chart shows, it has outperformed the A-shares index since inception. The market price of CAF also tells me something important. By trading at a 13.8% discount to NAV, it tells me how unloved China is. Closed-end funds do trade at a discount or premium to NAV based on investor interest. The popular silver ETF SLV trades at a 0.07% discount to NAV. A month ago, it was trading at a slight premium.



The bitcoin ETF GBTC has consistently traded at a premium, which it is maintaining even though bitcoin is in a bear market. Bitcoin has been declared dead over 300 times in its history, and it still finds more love within the financial markets than China!

CAF recently paid a 79 cent dividend, which equals a near 4% yield. Not only do I get to buy a fund that outperforms the Chinese index at a 14% discount to NAV, I also get a 4% yield while I wait for the discount to narrow and Chinese equities to start performing again. CAF is a classic Ben Graham style value investment, which is only available because China is scary. Jim Rogers made 42 times his money in Iran in the 90s. Was Iran scary? Yep. Was that risk more than reflected in share prices? I would have to guess yes. Likewise with China. There's a trade war, tariffs, Xi is dictator for life, they have a social credit system, they are blocking air and rail travel for dissidents, they ousted Jack Ma from Alibaba for being too capitalist and outspoken, the Communist Party is evil…. Yes, these are all true.

What's also true are the numbers and facts I outlined above. China isn't going the way of Venezuela. It is not even going the way of Brazil. Emerging markets with a dictatorial government are very scary places to invest in, but isn't this true of every country in the world now? Recall the actions of countries in the so-called developed world during the 2011 EU crisis. France, Italy, Belgium and Spain (also Greece and Turkey) banned short selling. The US banned short selling of banks during the 2008 crisis. Argentina confiscated USD bank deposits and substituted worthless pesos in its place. Hungary, Poland, etc have confiscated private pension funds. One fine Sunday, Cyprus was doomed. The world is a scary place, but as Satan's lovechild George Soros said, "the worse a situation becomes, the less it takes to turn it around, the bigger the upside". Money is made in EM when things go from truly terrible to less worse. China's woes are mainstream news. The downside may not be completely priced in, but in my opinion the upside outweighs the risk at this stage. I still wouldn't buy the index, but CAF gives me a value investment in an otherwise inaccessible market, and is hence worthy of a position.

CAF is a low-risk get rich slowly investment. This is something uncorrelated with the rest of the markets, uncorrelated to even gold and the miners. The #2 economy in the world, and its market, isn't going away. It's the ultimate contrarian *value* investment.

Link to fund details: https://www.morganstanley.com/im/en-us/financial-advisor/product-and-performance/closed-end-funds/emerging-market-equity/china-a-share-fund.html