



China A-Shares

Philosophy and Process



China A-Shares

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Overview

Baillie Gifford was founded in Edinburgh during the late Qing Dynasty (1908). For over a century, we have focused on investing in a truly active, long-term and patient way on behalf of our clients. Over the last 40 years, China has undergone an unparalleled period of economic growth and created some of the most exciting companies in the world. China's domestic stock-exchanges, known as the A-share market, were (re)established in 1990. The first overseas listing of a Chinese company in New York was in 1992 and Hong Kong in 1993. Our Emerging Market strategy has been looking at Chinese companies since its formation in 1994. We have had a dedicated China strategy since 2006. And with the greater accessibility of China's domestic markets offering an exciting opportunity for long-term active managers, we launched a dedicated China A-share strategy in 2019.







Investing in China

Strategy summary

The China A-shares strategy is a purely stock-driven, unconstrained equity strategy focused on investing in exceptional growth companies listed on the domestic stock markets in China (known as 'A' shares). The portfolio holds 25–40 companies listed on the Shanghai and Shenzhen stock exchanges and accessible via Hong Kong Stock-Connect. Over time we expect more utilisation of the Qualified Foreign Investor (QFI) scheme as well.

The universe of China 'A' shares has over 4,100 companies. Over a third of these are eligible to be bought via Stock Connect. The MSCI China A Onshore Index is the broadest and most representative index.

The portfolio is benchmark agnostic. The companies which we invest in are expected to benefit from, and contribute to, China's economic, societal and cultural development, and be capable of growing to a multiple of their current size. We take a long-term approach with an expected investment horizon of 5+ years. Our aim is to identify the exceptional growth businesses in China and hold them for long enough that the advantages of their business models and strength of their cultures become dominant drivers of their stock prices.

Our timeframe for analysis and ownership, as well as our upside focus, require a different approach and perspective. It is the stability and culture provided by our firm's partnership structure that allow us to pursue the truly long-term, active, growth investing.

What makes this strategy unique?

This strategy is unique in three ways.

- **Timescales** – in contrast to the short-termism of the average domestic market participant, it has exceptionally long holding periods.
- **Growth focus** – its core philosophy is centered on the asymmetry of stock returns and focuses on the upside of an investment case. We seek companies who have the potential for 5x returns. This requires a long-term focus and an ability to be imaginative about the potential for China's best businesses.
- **Perspectives** – it has the freedom to think differently and radically about investing.

The market		Baillie Gifford
Quarters	Timescales →	>5 years
Pessimism and loss aversion	Growth focus →	Optimism and upside
Narrow and homogenous	Perspectives →	Broad and diverse



A-shares strategy team

Shanghai research platform

Baillie Gifford's Shanghai office provides an 'on-the-ground' presence which enables us to deepen our long-standing relationships with existing holdings, identify the next generation of exceptional companies, better understand regional and cultural developments, and forge more academic partnerships within the region. Research conducted in Shanghai is used by portfolio managers in Edinburgh in the construction of portfolios. The scale of the opportunity and the pace of development in China are exciting. The opportunities abound for active, long-term investors in a short-term, momentum-driven A-share market which is under-researched and under-owned (by foreigners). As a platform to enhance our knowledge of China and Chinese companies, and to feed different perspectives into our broader investment strategies, our Shanghai office brings together local and global insights to the benefit of all our clients.

Edinburgh

Baillie Gifford has 125+ investors based in its Edinburgh office. Over half of these research Chinese companies. As at end December 2021, Baillie Gifford had US\$48bn invested in Chinese equities on behalf of our clients. The breadth of our research spans the listed and unlisted universe in China, providing insight into major long-term trends, disruptive opportunities and areas of proactive and positive governance. This approach has fostered relationships with company founders, industry specialists and academics who think in timescales aligned with our clients' interest, instead of the short-term focus of the modern financial world. When coupled with the wider perspective of a global approach that links to worldwide experiences and insight, our A-share strategy seeks to identify and own only those exceptional companies with the industry background, competitive advantages and quality of management to be positive outliers over the long-term.



Louise Lin

8 years with Baillie Gifford
8 years' experience
Based in Shanghai



Rio Tu

8 years with Baillie Gifford
8 years' experience
Based in Shanghai



Linda Lin*

8 years with Baillie Gifford
12 years' experience
Based in Shanghai



Freddy Zhu

2 years with Baillie Gifford
4 years' experience
Based in Shanghai



Tony Wang

2 years with Baillie Gifford
6 years' experience
Based in Shanghai



John MacDougall*

22 years with Baillie Gifford
22 years' experience
Based in Edinburgh



Sophie Earnshaw

12 years with Baillie Gifford
12 years' experience
Based in Edinburgh



Ben Buckler

11 years with Baillie Gifford
18 years' experience
Based in Edinburgh



Qian Zhang

1 year with Baillie Gifford
14 years' experience
Based in Edinburgh

*Partner.



How we identify exceptional companies

Our investment process can be broken down into three parts: idea generation, research, and portfolio construction.

Idea generation

Our objective is discovery rather than coverage. Our philosophy, time frame of analysis and long investment time horizons require a different approach. We are willing to look in different places to better understand the risks and opportunities of the Chinese A-share market. In particular, we find that relationships with industry thought leaders, academics and unlisted companies provide a valuable flow of ideas, and often a genuinely differentiated perspective. In addition, we work with over 125 investors across various strategies at Baillie Gifford, many of whom research Chinese companies. All bring a truly long-term, active, growth mindset.

Investment research

Research is at the heart of our process. Every new idea to the portfolio must be passed through our research framework, to ensure long term fundamentals are thoroughly analysed. The research framework comprises two separate approaches. First is a 10-question stock research agenda considers both the scale and sustainability of the opportunity on a 5–10 year view.

The 10 question framework encourages us to consider the scale of the opportunity for the company over the next 5–10 years along with the cultural and financial factors which will allow the company to capitalise on this opportunity. It is predominantly focused on upside potential. When conducting research, we will draw heavily on the Shanghai research platform which provides closer access to visionary management teams, independent academics and industry leaders in China. We aim to marry this local insight with the broader understanding and global context provided by Baillie Gifford's wider connections and the stock research of Baillie Gifford's global and regional investment teams.

10 Questions framework

-
- Q1** Do you contribute to or benefit from China's economic, societal or cultural development?
-
- Q2** Is there room to at least double sales over the next five years?
-
- Q3** What happens over the next five years and beyond?
-
- Q4** What is your competitive advantage?
-
- Q5** Is the business culture clearly differentiated?
Is it adaptable?
-
- Q6** Are your returns worthwhile?
-
- Q7** Will they rise or fall?
-
- Q8** Is management interest aligned with company stakeholders?
-
- Q9** Is it attractively valued? How could it be worth five times as much?
-
- Q10** Why doesn't the local market realize this?
Why doesn't the international market realise this?
-

We use the answers to the questions to help us construct a probability-weighted valuation, which looks at long-term scenarios for the value of a company and the likelihood of success.

In addition to the questions on governance, societal and environmental factors that are already built into our 10 question research framework, we have an additional proprietary due diligence checklist which looks further into ESG, management, ownership, financials and previous history. This may be supplemented by third party forensic analysis through our long-term relationships as and when required.

Portfolio construction

We believe that exceptional growth companies are rare. We adopt a concentrated portfolio approach of 25–40 holdings. This enables us to focus our efforts on companies that we think are truly exceptional and to own them in such size that the impact of each will be meaningful to clients. The weight of any new holding will be aligned with the enthusiasm for the stock among the group, and reflective of both its potential upside, the probability we associate with this, and the competition for capital amongst other holdings within the portfolio. Individual stocks are selected on their own merits with no regard for their weights in an underlying index.

The China A-share team meets weekly for formal stock discussions, alongside sharing ongoing research and threads of exploration. The investors meet quarterly to discuss the overall composition of the portfolio. This is in addition to the many ad hoc discussions that occur between the team in Edinburgh and Shanghai and our wider investment colleagues.

Once a company has been assessed through our 10-question fundamental research framework, the portfolio managers are responsible for making the ultimate decision on its inclusion (or otherwise) in the portfolio. There does not need to be consensus for a new idea to be bought for the portfolio. Strong emphasis is placed on backing individual enthusiasms rather than attempting to achieve consensus. The most rewarding investment ideas can be both controversial and highly uncertain to start with, and we believe requiring consensus on decision making would reduce our likelihood of buying such companies.

Our buy and sell discipline is based on the fundamental characteristics of individual companies. Given our long holding period, ongoing research is actually the longest part of the investment process. We live in a world with a lot of vertical changes. Being able to identify new growth engines and prospects for a company is important. On going engagement with the company leaders is important. We use our 10-question research framework to reassess the strength of the investment case on an ongoing basis. The inputs that these answers provide are then used to create a new set of long-term scenarios which together provide a probability weighted return. This allows us to assess whether the investment remains attractive.

Should the return no longer be sufficient to deserve a holding in the portfolio we will sell the holding. We do not have any triggers for automatic sales. The principal reason for a sale would be that the company answered the 10 questions less convincingly than before. Examples of situations that might lead to the sale of a stock include:

An adverse change in the fundamentals of the business (e.g. deteriorating demand or evidence that a company's competitive edge was not as strong as we thought);

A loss of confidence in management (e.g. where there are unexpected or poorly explained changes in management or where their actions are inconsistent with the long-term objectives);

A situation whereby a company's shares have performed well to the extent that the scope for substantiated upside has reduced, and there are better opportunities elsewhere.



We see risk differently

We believe that the main risk to clients is the permanent loss of capital, not how close the portfolio is to an index. In our opinion, long-term success in equity investing requires risk taking and ambition, not excessive caution and downside risk aversion. We have a strong conviction that our A-share portfolios should be concentrated and focused on the long term, with portfolio positioning reflecting the upside potential we see in individual companies, rather than market capitalisation or any other benchmark-based metrics. It is the perceived uncertainty in an investment case that allows for the existence of substantial upside, and it is only through genuine and material differences to indices that we can hope to do a truly admirable job for our clients.

To this end, we believe many of the traditional risk tools are unhelpful. We do not intend to measure tracking error and we eschew the underlying assumption that the benchmark is a risk-free option for equity investors. We also find MSCI-based sectors unhelpful as a risk management tool as they are often poor descriptors of a business and its risk profile. They are often broad and not reflective of an underlying commonality. This is particularly the case in China where the speed of development and addition of companies to indices are rapid and constantly changing. The large number of state-owned enterprises in the index and state involvement across a range of sectors also require an additional lens in terms of analysis of both opportunities and risks.

In addition to thinking carefully about the fundamental case for each individual investment in the portfolio, we manage the overall portfolio within a series of investment guidelines which are intended to ensure that there is a sufficient level of diversification in the portfolio. We believe that these controls are prudent in the context of the portfolio's overall objective of maximising returns over periods of five years and beyond.

Key characteristics

Benchmark	MSCI China A Onshore Index
Number of holdings	25–40
Maximum stock positions	Max 8% at time of purchase, 15% absolute
Minimum number of sectors	5 (with a minimum of 5% in at least five)
Thematic risk analysis	25% in one category triggers annual thematic review
Liquidity	\$1bn market cap or above (at time of purchase)

We group stocks by the long-term growth drivers we have identified in our investment research, which is a subjective process, but we believe that it is more consistent with our view that the real risk in the portfolio lies in the growth opportunities identified for individual companies not playing out, rather than how index providers choose to classify the companies in the indices. These thematic concentrations are expressed in an Euler diagram.



Based on representative portfolio as at 31 December 2021.

Conclusion

This shift from a poor developing country to a major economic power in just a few decades has been spectacular. It has forced other countries to ask how China's rise may impact their economic interests and global influence over the next century. China's inclusion in global bond and equity indices has also shone a light on the ongoing capital market reform process and the opening of its domestic markets to the world. We believe the speed and scale at which innovation and development have taken place cannot be overlooked. China has already produced some of the biggest and most innovative companies in the world.

We at Baillie Gifford have been looking at the A-share market for over a decade. A poorly researched market dominated by short-termism with large return dispersions is an exciting one for patient, curious stock pickers.



People

Investment managers



John MacDougall

John is an Investment Manager and member of the Long Term Global Growth (LTGG) and China A-share Teams. He has been a Partner in the firm since 2016. He joined Baillie Gifford in 2000 and after a year in the North American department John joined the Japanese team where, from 2007 onwards, he managed the Shin Nippon Investment Trust which invests in high growth, small and medium sized companies. In 2011 John moved to the Global Discovery team which focuses on identifying rapidly growing, innovation led, smaller businesses from around the world. During this period, he had a particular focus on unearthing new investment opportunities in Emerging Markets, and Asia in particular. He joined the LTGG team in 2015. John spent two years in Shanghai as Chairman of Baillie Gifford's China office before returning to Edinburgh in January 2022. John graduated MA in Ancient & Modern History from the University of Oxford in 2000.



Linda Lin

Linda joined Baillie Gifford in September 2014 and became a Partner of the firm in May 2022.. She is an Investment Manager and a member of both the China A-Share team and the Long Term Global Growth team. After five years in Edinburgh, Linda relocated to Baillie Gifford's Shanghai office in December 2019 as Head of the Investment Team. Prior to joining Baillie Gifford, Linda spent four years as a global equity analyst with Aubrey Capital and two years in real estate investment in China. She graduated BComm in Accounting and Finance from the University of Auckland, New Zealand in 2007 and MSc in Finance and Investment from the University of Edinburgh in 2011. Linda is a native mandarin speaker.



Rio Tu

Rio joined Baillie Gifford in 2014 and is an Investment Manager and member of the China A-share Team. Rio is based in our Shanghai office, having previously spent five years in Edinburgh. He previously worked in the Global Income Growth and Emerging Markets Teams. Rio is a CFA Charterholder. He graduated MA (Hons) and MEng in Engineering from the University of Cambridge in 2008, after which he remained at the University, working as a research student in the Department of Engineering. Rio is a native mandarin speaker.



Louise Lin

Louise joined Baillie Gifford in September 2014 and is an Investment Manager and member of the China A-Share Team. Louise is based in our Shanghai office, having previously spent seven years in Edinburgh. She has previously worked in the Japanese Equities and Global Discovery Teams. Louise is a CFA Charterholder and graduated MMath in Mathematics from the University of Oxford in 2013. Louise is a native mandarin speaker.



Sophie Earnshaw

Sophie joined Baillie Gifford in 2010 and is an Investment Manager in the Emerging Markets and China A-share Teams. She has also been Co-Manager of the China Fund and a member of the International All Cap Portfolio Construction Group since 2014. Sophie is a CFA Charter holder. She graduated MA in English Literature from the University of Edinburgh in 2008 and MPhil in Eighteenth Century and Romantic Literature from the University of Cambridge in 2009.

Investment Analysts



Freddy (Yixuan) Zhu

Freddy joined Baillie Gifford in 2020 and is an Investment Analyst and member of the China A-share Team. Freddy is based in our Shanghai office. Before joining Baillie Gifford, Freddy spent two years as an investment analyst at CICC focusing primarily on the energy sector. He graduated MA in Energy and Environment from Johns Hopkins University, MA in International Relations from Tsinghua University, and BA in Economics and Finance from Tsinghua University. Freddy is a native mandarin speaker.



Tony Wang

Tony joined Baillie Gifford in 2020 and is an Investment Analyst and member of the China A-share Team. Tony is based in our Shanghai office. Before joining Baillie Gifford, Tony spent four years as an investment analyst at CIC in Beijing. He graduated MA in Financial Mathematics from Columbia University and BSC in Applied Mathematics at Tsinghua University. Tony is a native mandarin speaker.

Client Service Director



Ben Buckler

Ben is a Client Service Director in the Clients Department and Chairs the China Product Group. He joined Baillie Gifford on the Investment Management Graduate Scheme in 2001 and was an Investment Manager in our Emerging Markets Team until 2008, when he relocated to China. Ben worked in Hong Kong for six years as an Executive Director in the Asian Equities business at UBS. He returned to Baillie Gifford in 2018. Ben is a CFA Charterholder and has an MBA from the University of Oxford. He graduated MA in Geography from Mansfield College, Oxford in 2001.



Qian Zhang

Qian Zhang joined Baillie Gifford in 2021 as an investment specialist and client service director in the Emerging Markets Client team. Previously, Qian worked as a senior client portfolio manager covering emerging markets strategies at Pictet Asset Management and JPMorgan Asset Management. She began her career at Merrill Lynch in 2008. Qian graduated MSc in Mathematical Risk Management from Georgia State University and BSc in Economics and Statistics from Peking University. Qian is a native mandarin speaker and a CFA Charterholder.



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