

FCL*Capital*

May 2018

Thesis: Long position on the CSI300 index

1. Introduction

This house will readily admit it: we are inveterate China bulls.

Running a BRIC focused equity fund, it would be an astonishing announcement if we were not. Like the saying goes, “never ask a barber if you are in need of a haircut”.

That being said, this letter will discuss the reasoning and assumptions behind our investment in the CSI300 index, a position held by our FCL Hedge fund, why we think the rise of Asia, and most specifically China, is the most important event of the 21st century alongside with blockchain and the internet and a little bit about the impressions of this manager about his recent trip to China.

Finally, we will discuss why we think any investor should have some exposure to the CSI300 to a greater or lesser degree and why we think this position is a good way to capture the future growth of the soon-to-be world’s largest economy.

2. Perspectives on China: past, present and future

The rise of China, the country that is going to define the 21st century, has been nothing short of extraordinary.

From an absolutely insignificant country made of subsisting farmers back in 1979, China's relentless openness and growth has already produced historic milestones.

In arguably the first one, China became the world's major consumer of steel in 2001, when it was still beginning to build its massive new urban cities and infrastructure. A few years after that it became the planet's biggest trader (exports + imports).

Then in 2016 it surpassed the US as the world's largest economy when measured at Purchasing Power Parity, a position occupied by America since 1872.

Overpowering

Year in which China: **overtook** / **overtakes** the United States

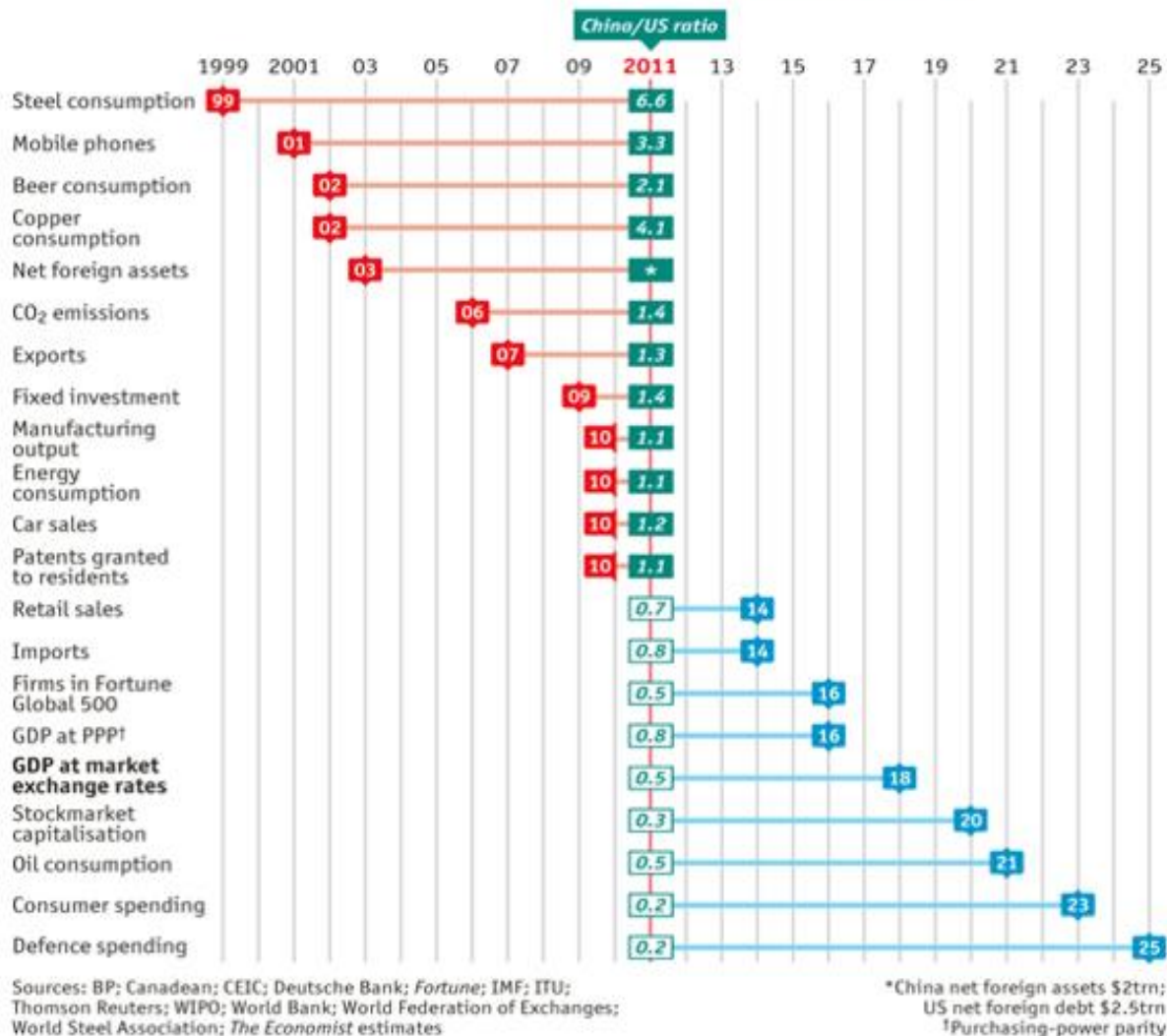


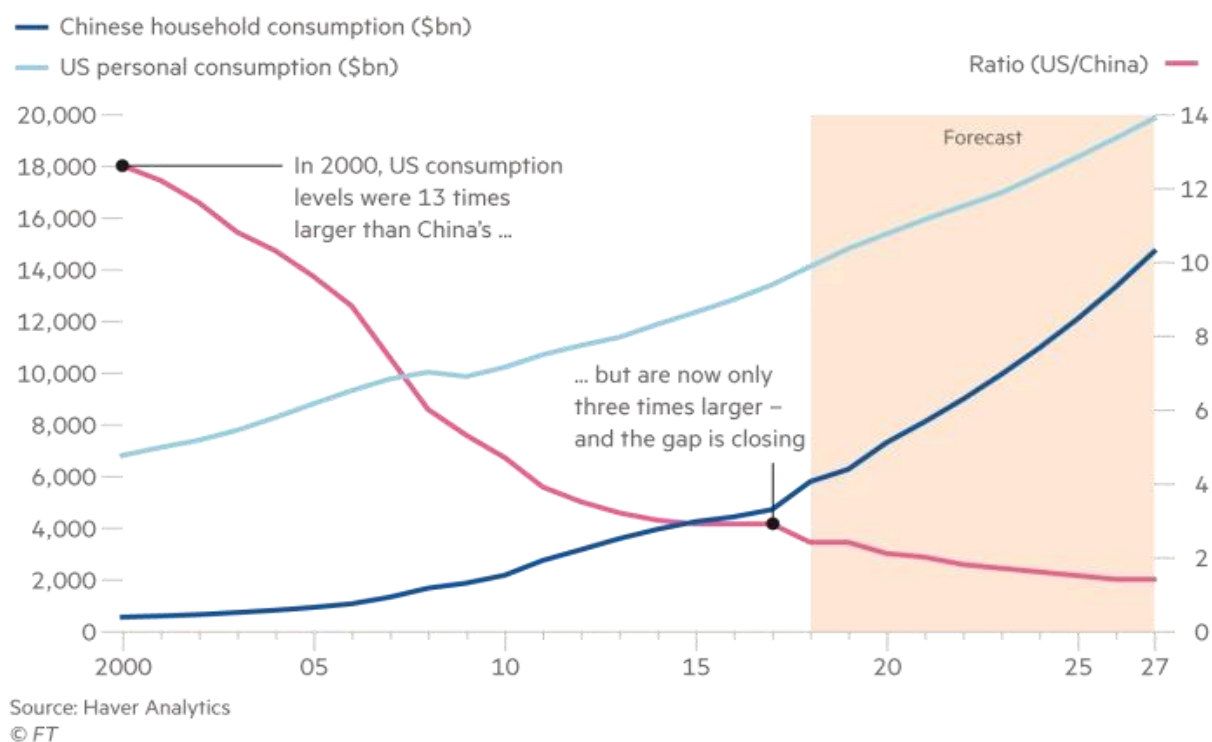
Table from the IMF in 2012 about China's milestones. Now in 2018, GDP at market rates should wait until around 2024 to overtake US levels and consumption should only reach US levels around 2030. The rest is still very much accurate.

The fact is that just as US consumption changed the world with its unprecedented scale in the 20th century, Asian consumption and modernization will make the world pulse in the 21st century.

This is not to say the road ahead is without challenges. GDP, as our readers know, is a composition of different factors. In the US, consumption is clearly the major driver of demand, comprising around 70% of GDP. In China, on the other hand, due to historic factors (lack of social safety net, a thrifting culture, political options that put interest rates below their natural level for a long time and channeled funds to state enterprises) its consumption to GDP ratio is below 40%, a historically low level.

The good news is that China's leadership, as always, is attentive and aware of the problem which is already being attacked. The bad news is that while China's GDP will surpass America's soon, it will probably take a decade or more for China's total consumption to surpass America's. In a remarkable chart, the economist Martin Wolf tracks the US multiple of consumption in relation to China. From more than 13 times larger back in 2000, US consumption will only be twice as large at the end of this decade and is already less than three times now.

Consumption in China and the US

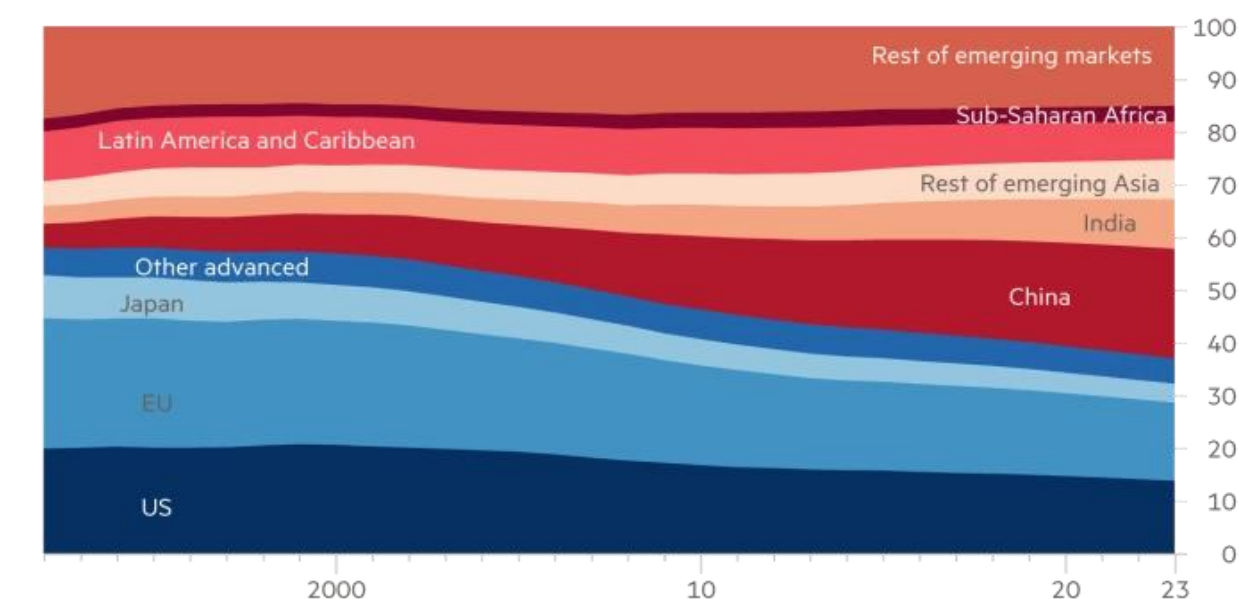


Powering all of this are the modernization drivers we see in most rising economies: urbanization, increasing education, improvement in transparency and in ease of doing business, rising literacy and access to education.

The consequence is that we are all going to live in a world powered by the BRICs, especially China, and to a lesser extent, India, with the US and Europe still making a significant amount of the global economic pie.

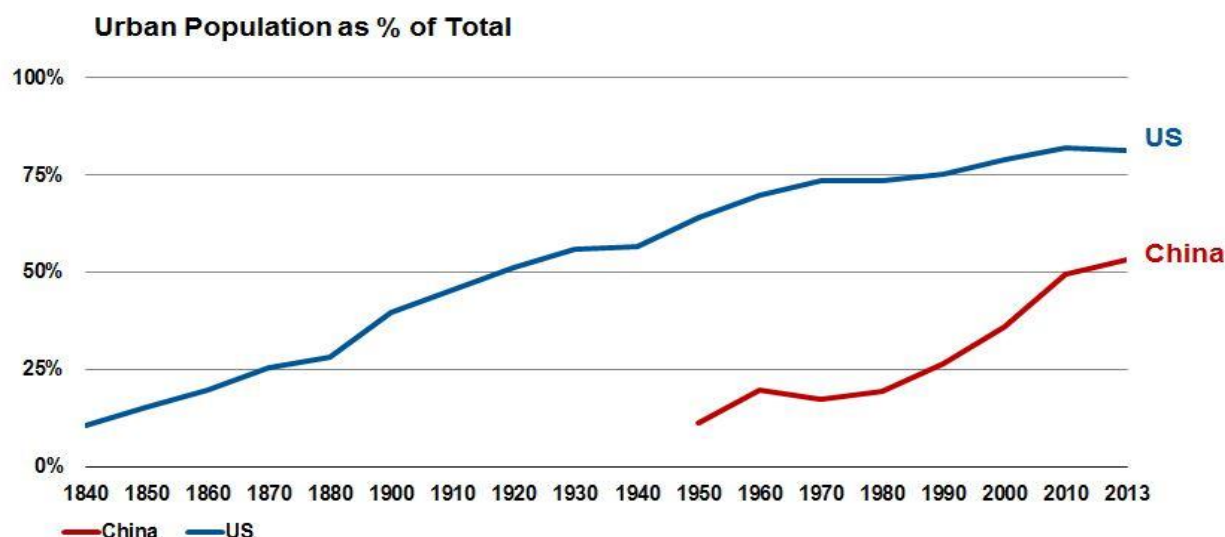
At the global level, the world is less unequal than it used to be

Share of world GDP (at purchasing power parity)



Source: IMF
© FT

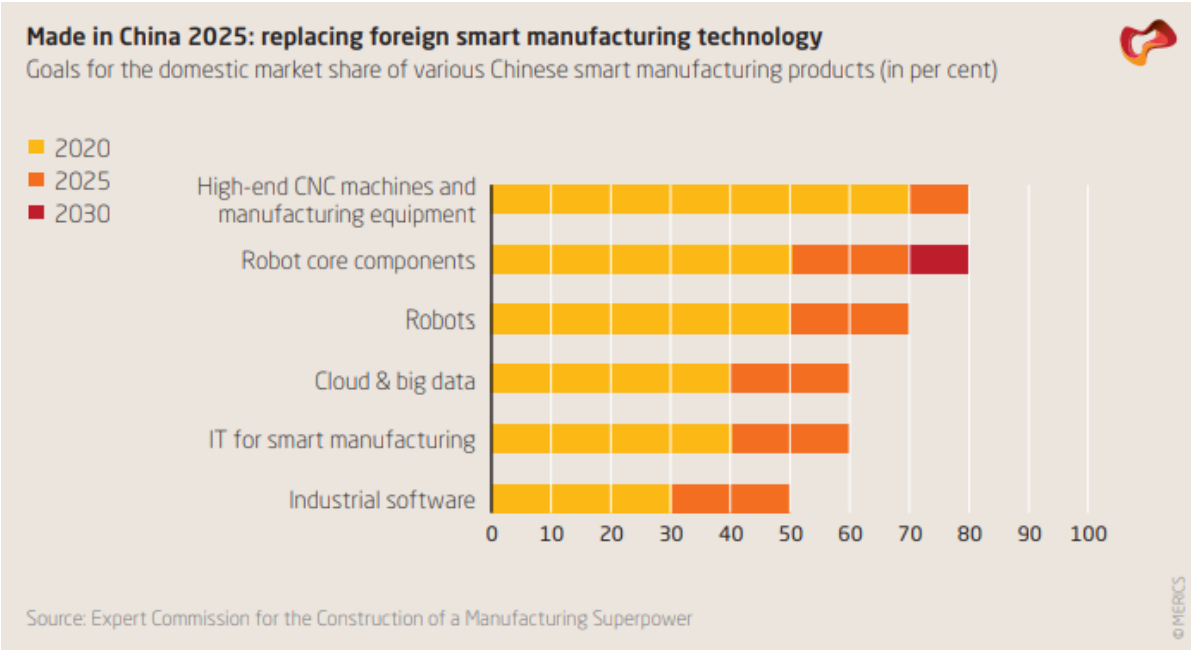
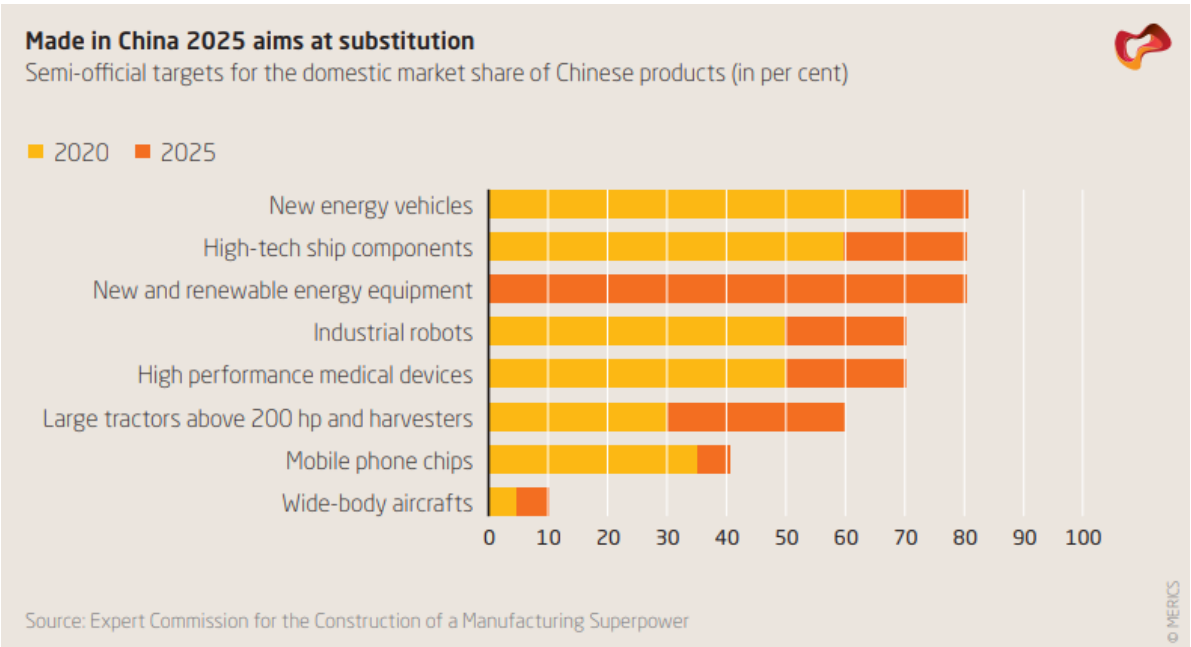
China: Urbanization

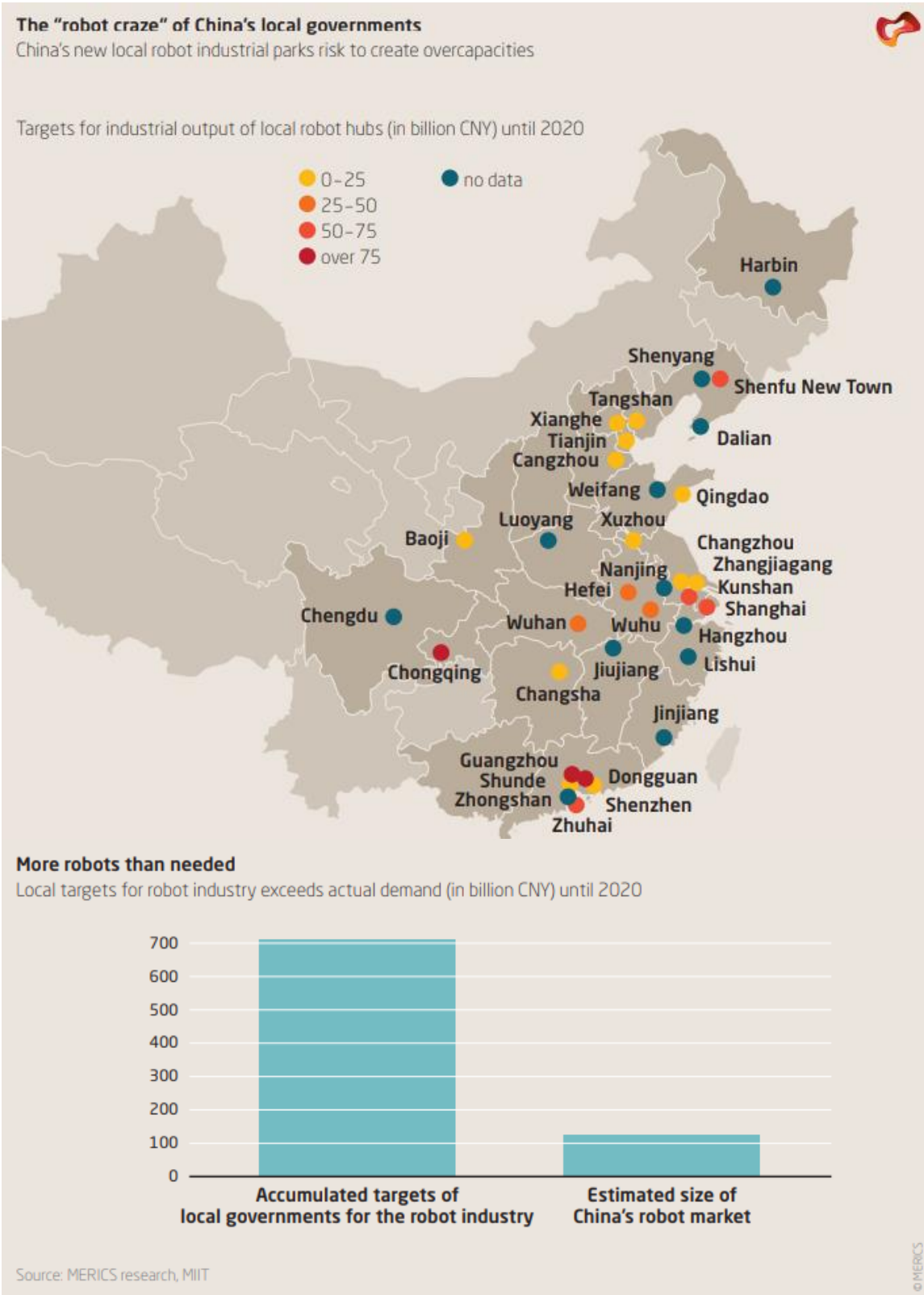


Sources: US Census Bureau, World Bank.

But just catching up no longer does justice to China's march. The fact is that now that the country is getting closer to the technological and economic frontier represented by the US, its leadership wants to start to "show the way ahead" and to see many of China's companies in leadership positions in cutting edge sectors of the economy. In other words, China's vision for the future is no longer only paying catch up to the frontier, but eventually becoming the frontier itself.

Maybe no single initiative in this front gained more notoriety in the western world than the now infamous "made in china 2025" plan, where the Chinese leadership outlines ten "strategic" industries where it envisions the country with aggressive global market share goals in the middle of the next decade.





The reaction by the Trump administration and some US think tanks couldn't be more strident: The US council of foreign relations declared that the made in china 2025 plan "is a threat to the US technological leadership" and the Trump administration urged china to "drop it" or face sanctions.

While this house with its libertarian ethos will never advocate for industrial subsidies, it seems clear to us that China's development path, except for its continental scale, is not really different in terms of actions and procedures to the ones that many other nations took at similar stages of development. It strikes us that the real worry of the Trump administration, has a lot less to do with tariffs or any harm to US companies but as a badly disguised and desperate attempt just to stop or at least delay China's progress. And it won't succeed for obvious reasons.

So, for the remaining of this thesis this is this house's base scenario:

- China's road ahead will be bumpy, just like the US was in the early 20th century, but the country will keep opening up (at least in economic terms) and progressing.
- A long-term model might resemble present day Singapore and Hong Kong.
- China's GDP will surpass the US GDP at market levels around 2024 and its consumption will surpass US levels around 2030.
- As of now, China's GDP is 18% of the world's total at PPP rates and US is 16%. We think China's share should keep rising at roughly one point per year until around 30% - 35% somewhere between 2030 - 2035 where it will plateau and then gently decline because of a rising share from India/Africa/Middle East with their fast-growing populations.

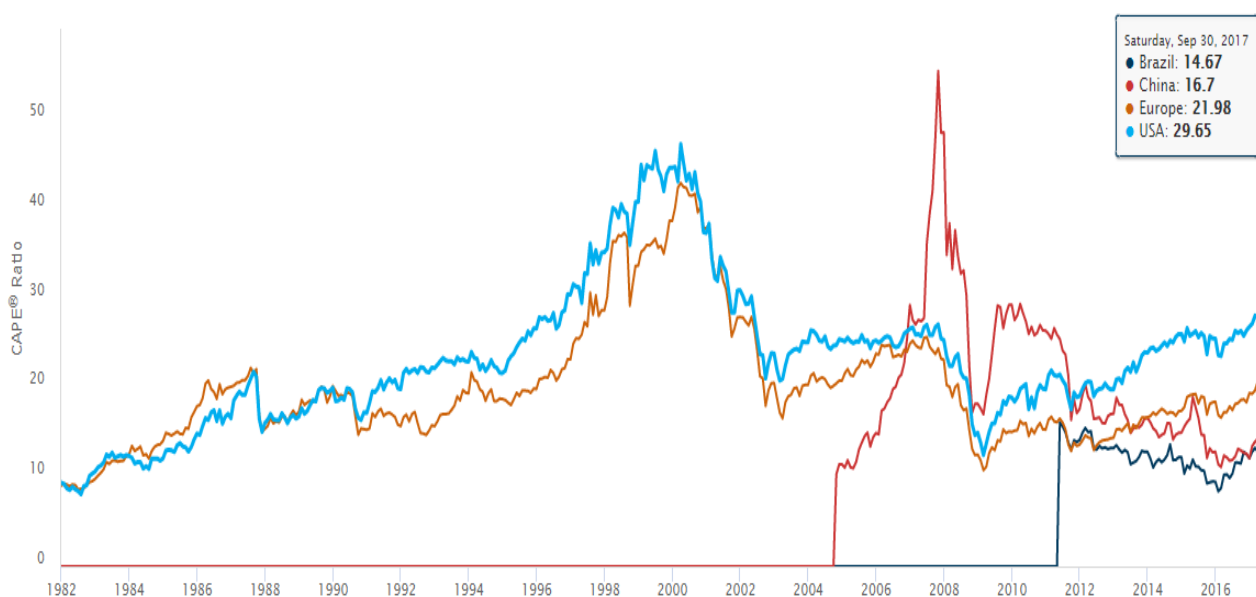
China will certainly face crisis and bear markets. But over the long term its stock market should rise with its economy. Why is that so? Especially in light of evidence that GDP growth doesn't necessarily translate into stock market gains?

Because while this might be true over a year or even a few years, over the long term, a larger economy will mean a larger profit pool.

If we assume that: a) the share of company profits in the total economy remains constant; b) investors have a claim on a constant proportion of those profits; c) valuation ratios are constant; d) the country's stock market only lists domestic companies; e) the country's economy is closed, then we would expect an exact match between real price increase and real GDP growth.

Furthermore, the most important point for an index longer term returns is valuation. And if we take the Shiller PE ratio, China's stock market, even considering growth three times faster than US levels, is a lot cheaper and where one can find a lot more information asymmetry than the hyper efficient US stock market.

Historic CAPE® Ratio by country



To summarize, the world's soon-to-be largest economy and, still being an emerging market with a stock index that is one of the cheapest and less understood in the planet and with a rising share of the world's leading companies and many of them still unknown to most western stock pickers is, for this house, the investment opportunity of our time.

And finally, a word on China's exchange rate. It was in vogue around 2015 among some New York fund managers the thesis that China had an overvalued currency and was about to face a financial crisis.

While it was true that there were some massive amounts of money leaving the country, probably more due to the increasing crackdown on corruption and illicit money and some worried about political instability, this house was never really convinced that a country with a massive current account surplus and PPP levels that suggested the currency was actually cheaper than it should be for its level of development should have a cheaper currency than it had.

In fact, we suspect everyone says that China has an expensive currency never actually spent time in the country and realized there are not many places in the US where you can have an amazing dinner for less than \$10.

So, part of our thesis is that China will not only avoid a balance of payment crisis but, as economy theory dictates, that it should gradually converge to European and US levels at purchase power parity as its per capita income gets a little bit closer to developed countries, as proposed by any introductory economics textbook.

Renminbi PPP levels



The renminbi is still around 40% undervalued compared to the US dollar at PPP levels as China's lower per capita income would suggest. Over time this gap should close.

So, in the next section we dig deeper in the numbers. But first, a little bit of history surrounding this opportunity.

3. Some financial history

To navigate the fragmented Chinese financial markets, some perspectives and history is in order. To this date, investing in mainland china is not without challenge: capital controls and uncertainty regarding the financial environment, combined with the occasional quota system, makes a specific proposition. Granted, the door for international investors has been gradually opening and this house has no doubt that the future of Chinese financial markets will involve investment flows in and out of the mainland.

But on the date of this thesis, May 2018, direct access to Chinese companies would involve one of three options:

1. The so called ADRs, Chinese companies listed in the American stock markets, like Alibaba, JD, YY and dozens of others, especially tech names.
2. Investing in the Hong Kong market which has hundreds of mainland China companies including Tencent. Hong Kong is, after all, China's gateway: the way for the outside world to do business with China and the way for China to look abroad while still being in China.
3. ETFs and other instruments that mimic mainland China companies but are traded in western markets like the one that is the scope of this letter.

Hong Kong Bay



Visit to DJI – world leader in drone production



There are many ways to “play China.”

Our Opportunities fund has stakes in YY a video streaming company with a business model that is still being gradually understood by American investors, VIPs, a flash discount sales portal once again with no perfectly direct comparable in western markets and Fu Shou Yuan, which was discussed in length in one of our past letters.

The fact is that for the foreseeable future China will have different moving parts when it comes to its stock market. A very traditional and state heavy Shanghai stock market, a more freewilling and experimental Shenzhen market. Both still not very accessible for those outside China¹. An international gateway in Hong Kong which we feel will remain China’s and Asia’s most important market in the coming decades and a non-negligible portion of elite companies listed in New York City.

The focus of this letter will be the position we have in the ETF mimicking CSI300 which is a hybrid of names in the Shanghai stock exchange, more focused in traditional sector and government owned companies and the more freewilling, more private sector heavy and tech heavy Shenzhen stock exchange.

While we understand and respect more sector directional investors willing to access China’s tech sector or China’s consumer companies for example, we feel the CSI300 is still the best way to have exposure to the whole story of the Chinese economy. This makes this thesis very little correlated with our specific Chinese names in our portfolio like YY and Fu Shou Yuan and this gives us a possible upside to the Chinese story because unlike, say, the Brazilian stock exchange which is heavily focused on specific commodity companies and banks, the Chinese markets are indeed very responsive and very correlated to the overall economy.

¹ Stock connect and the gradual capital account opening will in time change that

But growth alone doesn't make any asset attractive. Quality and valuation are what matters. So, let's dig in.

4. Anatomy of an index

Many things were said in the past about the quality and corporate governance of major Chinese companies.

While we can argue extensively about both, one thing few people would argue is that the direction of change for both is a rapid convergence to western standards.

For the quality, China went in a couple of decades from being a "low cost sweatshop", to "just copying what's done in the west", to reaching and in some cases even surpassing what's best about American and European companies.

Alibaba and Tencent are no less formidable and innovative companies than Amazon and Apple. Midea and Moutai are probably stronger and with a brighter future than, respectively, Phillips and Diageo.

Even government-controlled companies are reforming, have some rigorous systems in place and are better managed than, say, Brazilian or Russian state-owned giants. And that's even before factoring in the fact that government-controlled companies and SOEs form a diminishing share of the total economy and therefore of the Chinese stock market.

As for corporate governance, in spite of some well publicized frauds (bad apples undoubtedly exist, and some are still hiding) every rigorous analysis shows that the percentage of frauds is not only falling but not much higher than anywhere in Europe or North America.

But old visions die hard.

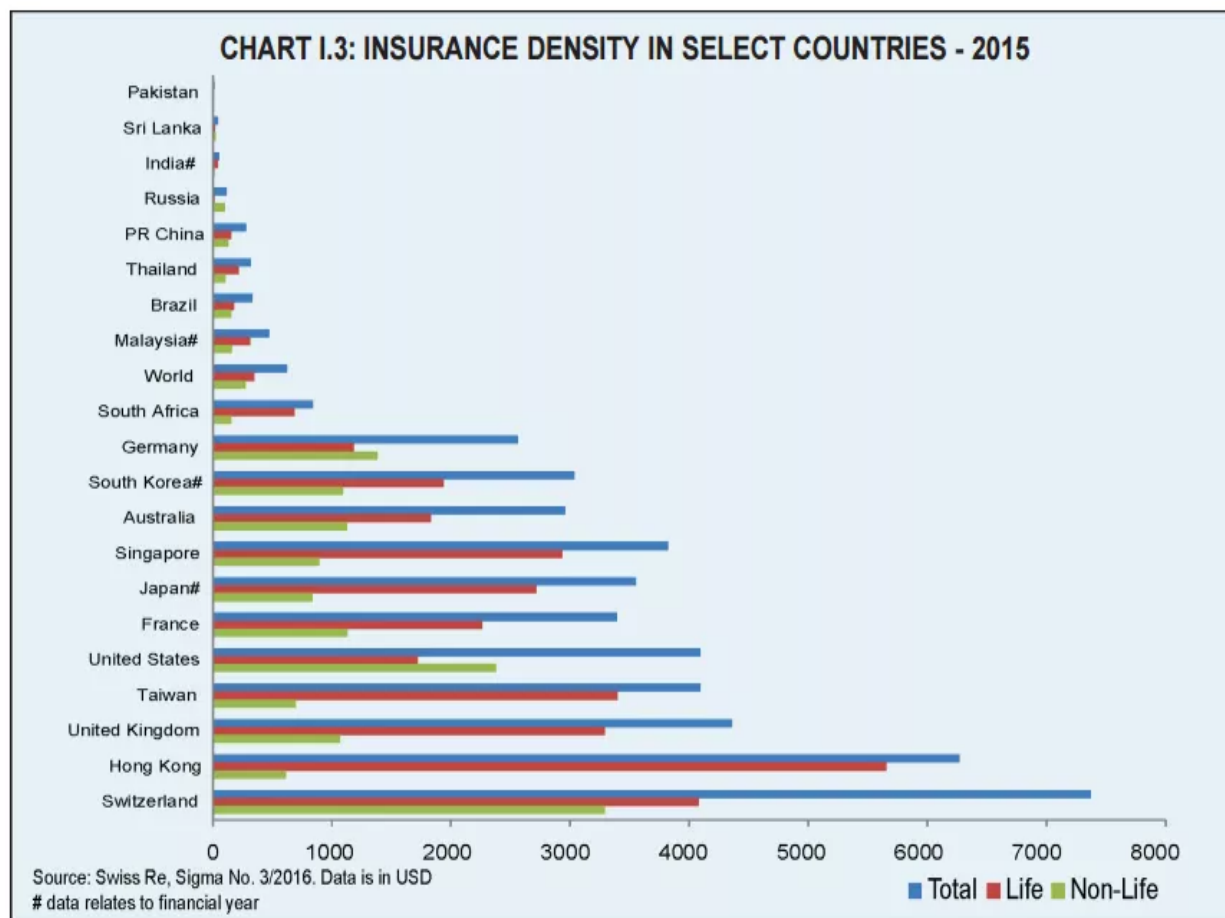
With all this background and due to its improving governance, we judge China's stock indexes should have at least a similar multiple to European indexes. But in fact, China trades like a no growth country, like Japan and Italy and just a little bit higher than basket cases like Russia. The US levels, with its stratospheric levels are another matter.

And China, with its vast and growing internal market, also offers diversification: the good thing of having a still relatively closed financial system is that financial crisis when not completely global and catastrophic, usually don't reach its shores. In other words, despite being the most important emerging market, China offers as much diversification benefits as a frontier market that is almost completely closed to the global financial system.

So, let's take a deep look at the stuff the CSI 300 is made of.

Ping Ang Insurance	5,94%
Kweichow Moutai	3,44%
China Merchants Bank	2,54%
Midea	2,26%
Gree Electric	2,08%

Among the top five components we see Ping Ang Insurance, the country's largest insurer and a very promising play on china's underpenetrated insurance market that will probably rise to become the world's largest someday



We see Keowcheou Moutai, a baiju brand (a strong local distilled rice liquor) with centuries of history. Just to remain in one example of how strong and symbolic this company is, just consider that it was given to Richard Nixon on the first visit by a US president to China by the then Chinese premier to toast the re-approachment of the two nations.

Moutai vs. Diageo USD Market Cap Comparison



A toast with Moutai Baiju



Finally, Midea, listed number four in terms of weight in the index is an appliance company that is not only profiting from the country's urbanization and premiumization, but also has a strategic investment in Kuka, one of the planet's top robot makers that will ensure the company is a leader in this strategic industry in the coming decades



To summarize, we like not only the Shanghai Shenzhen 300 valuation, which seem as overly discounted compared to most western markets but also the improving quality and governance of its companies, that are closing the gap with its western peers at a much faster speed than American and European investors are realizing.

In fact, we see a similar pattern to what was seen in the US a century ago: first a plethora of non-trustworthy local brands and foreign brands enjoying a premium in brand power, pricing power and, then gradually, with a mass consumer market being formed, local solutions, more attuned to local tastes and expectations start to form and local companies start to displace to a large extent the foreign players.

We see the story of the giant Chinese consumer market with many winners including obviously American and European companies, but above all local players, many of them part of this index.



Chart CSI 300 index this century: price/earnings & Price to Book Ratio

If we further assume that: the share of company profits in the total economy remains constant; investors have a claim on a constant proportion of those profits; valuation ratios are constant; the country's stock market only lists domestic companies; the country's economy is closed, then we would expect an exact match between real price increase and real GDP growth².

² [ps://www.msci.com/documents/10199/a134c5d5-dca0-420d-875d-06adb948f578](https://www.msci.com/documents/10199/a134c5d5-dca0-420d-875d-06adb948f578),
<https://personal.vanguard.com/pdf/s338.pdf>

5. Risks and the way ahead for China

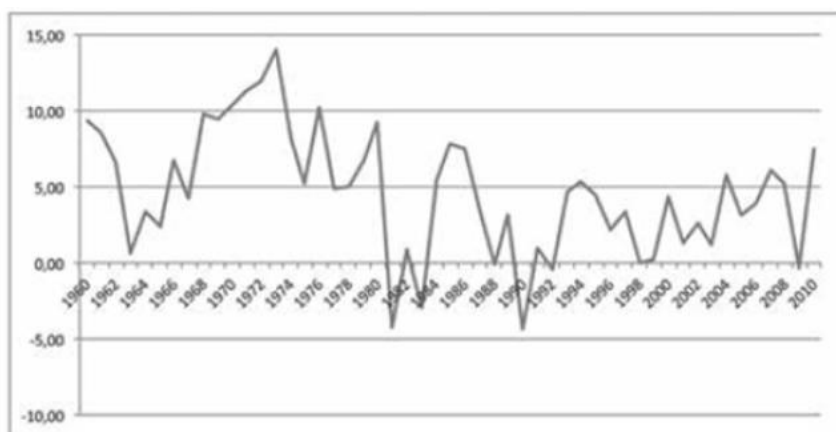
If the story of the 20th century was that around 10% of mankind (some 500 million people mostly in the USA and Europe and Japan) had access to goods and services and were part of the global village of finance and trade, while 90% of humanity was trapped in subsistence levels, this house believes the story of this century is that Asia, with 4 billion people and many of them converging to western levels of investment and consumption will dictate the rhythm of the global economy.

Just like the streets of New York City were not paved in gold at the turn of the 20th century, China will face many challenges ahead.

We highlight:

1. The threat of the middle-income trap

Being from Brazil, I raised the point to countless Chinese: spend some time to study my country. Brazil was once a “rising superpower” just to become the poster child of the middle-income trap.

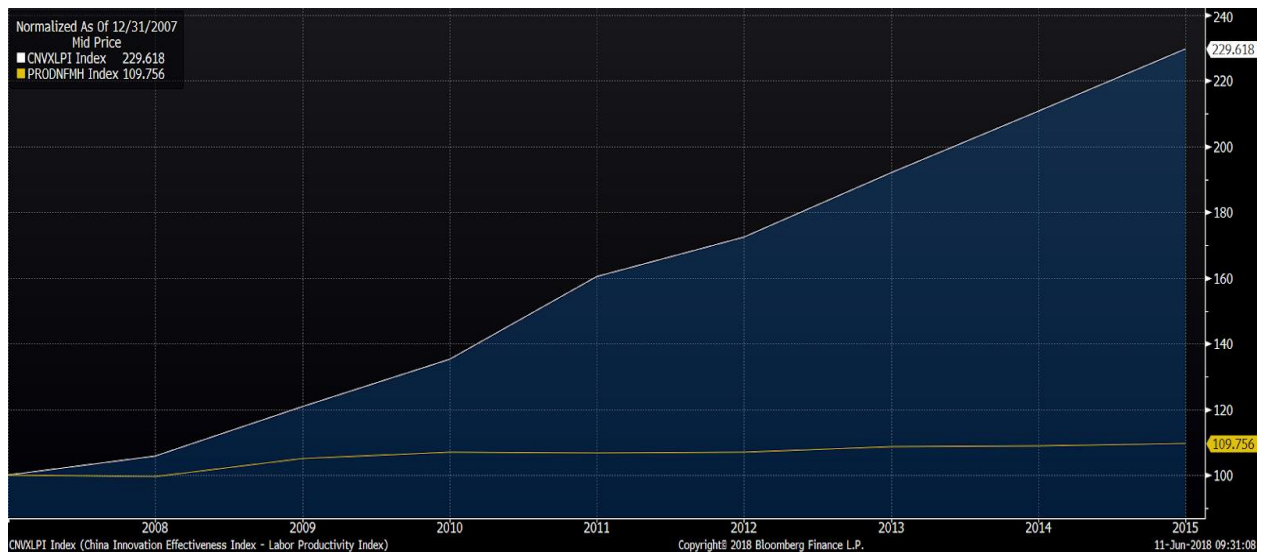


Source: World Bank National Accounts Data, and OECD National Accounts data files (s. d.)

In retrospect, it should be obvious the country didn't have what it takes to reach developed income. It simply didn't form an educated population, improved its infrastructure and liberated its business environment.

To summarize, while its low income to middle income trajectory was similar to China's (with a smaller population but similar sized territory) its path from middle income, we think, will be very different.

Chinese people are becoming more educated and its infrastructure is pressing ahead.



Productivity growth vs US: 2007-2015

2. Internal crisis.

The fact is, no one completely knows what is going on in China, including its leadership. With 1.3 billion people and dozens of languages and ethnicities, a lot could go wrong.

The fact that it hasn't is amazing in itself.

A not often reminded fact stays in our heads: if we want to understand possible unrests in China, we would look not only to its rural Houkou holders that work in cities but simply to its borders. Most Chinese borders are in themselves sources of unrest. As we know, 92% of Chinese population is Han, but most of the other people are in border areas in the west (Tibet is the most well-known but several ethnic and linguistic conflicts abound)³.

That being said, we still see China's current leadership in charge and being able to manage its internal and border related conflicts for the next few decades. China simply has a lot going on for it. And once people start to taste prosperity, they become different. And a lot of prosperity is going to be found in China in this century.

Also, for all its criticism, we should remember that westerns don't exactly have a pure history when it comes to its borders and its management of different ethnic cultures. Europe with its centuries long colonization and exploration of far flung lands and the USA with its territorial expansionism, sometimes through coercion, sometimes simply through wars.

³ <https://www.pri.org/stories/2010-10-26/borderland-chinas-14000-mile-struggle>

3. Will China step back from the world?

Since the 19th century Opium wars, China has been very suspicious of foreigners. They credit them with a century of humiliation and blame them for the country's backwardness for most of the 20th century.

We fear a new cycle of closeness could roar back.

At the same time, we judge this a limited possibility and a risk worth taking.

One only needs to wander through the Chinese cities to see what the openness cycle that started in 1979 has done to the country. How promising is their place in global affairs right now?

How could someone ruin this? We don't see this a zero possibility (nothing is) but we see this, on balance as a very unlikely scenario.

To summarize, we think that though trials and tribulations China will march back.

We think its stock index should be held by any longer-term stock investor: it provides good diversification benefits for investors engaging with American and European shares and even to stock pickers that like Chinese consumption names like this house because this index, with its real estate, banks and financial companies besides tech and consumption names give a more holistic exposition to the Chinese growth story.

And finally, the reader might ask, why now? While this house is always inclined to think long term, we can't deny that the imminent inclusion of China's domestic index in the MSCI world market is important in several ways. Not only because of the money flows that will be facilitated and the likely better pricing of Chinese listed companies but because of the symbolic inclusion of Chinese markets in the global financial system.

We think this index should trade on par with the S&P 500 given China's improving corporate governance, higher economic growth and increasingly prominent global champions in diverse economic areas. Indeed, several names in this index will probably go on to dominate their industries.

After several failed attempts this manager finally was able to see a bottle of Mutai Baiju displayed at a prominent restaurant in Hong Kong. Most of those these days go on to auctions for astronomical figures.

After consulting the price in the menu, I too gave up on the idea of trying Keowcheou Moutai. Out of my business trip budget.

"These used to be cheap until a few years ago" the restaurant waiter told me. "Now everyone knows about them, including foreigners".

As I enjoyed my lunch, I couldn't stop thinking about that as an apt metaphor for the Chinese stock market as a whole. Don't wait until everyone has realized how precious it is.

FCL Team.

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