Bin Yuan China Equity Strategies Review- Second Quarter 2013

Market Overview (H share only)

We told investors last year that the market still overestimated corporate earnings and GDP growth, and it needed to be lowered at least for the first three quarters in 2013. Within our expectation, the release of the weak macro and corporate data has hit the equity market severely for this quarter, with MSCI China index down by 9.1%. On a sector level, Information technology and consumer staples were the big outperformers gaining 16.37% and 3.5% respectively during the period, followed by Telecom and healthcare up largely by around 8%. On the negative side, Energy, materials and financials were the bottom three performers for the quarter.

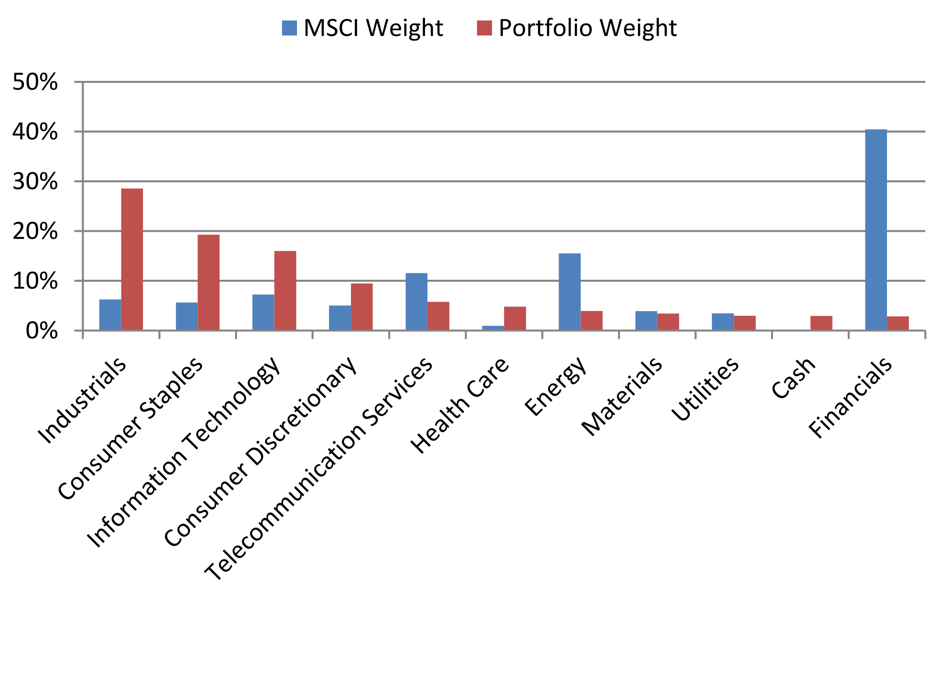
The economic and market condition has not changed much since our last quarter review. The problem of off balance sheet products provided by financial institutions continues to surface and has attracted increasing attention from the central bank. At the end of the quarter, a couple of local banks had liquidity problems and the SHIBOR rate has reflected this issue by increasing sharply in June, raising concerns of panic amongst some investors. The short term liquidity has been tight not only due to central bank in a tightening mood; the deterioration of corporate cash flows in addition to structural problems of the financial resource allocation add to this concern as well. We believe that the true GDP growth is below 6% while market consensus is still expecting 7% and above. The over-capacity situation is broad based, including all sectors that are related to fixed asset investment spending. Furthermore, Inventories were still at high levels with weaker demand - A share listed company inventories are up 43% in 1Q2013 with revenue up only 8%, and the weaker PMI data echoing the soft economy.

Portfolio Positioning

As a long only focused portfolio, the fund holds 25 stocks as of June month end. We still believe that the Chinese economy has structural issues after high growth in the past 20 plus years. In line with our view, we sold all of our bank and property holdings in the Greater China fund during the quarter after April/May sector reviews, as we are still not comfortable on the situation surrounding local government debt, off balance trust products and maintain a cautious long-term view on banks and other financial institutions due to potential deregulation of the interest rate. High returns in the bond market are not sustainable as it is a strong representation of the inefficient market caused by regulated interest rates and currency, which we believe is overvalued. We believe the interbank liquidity issue in late June will force financial institutions to reduce their off balance sheet businesses, which will slow down earnings growth across the board. The other financial risk which may surface at a later time is the local government debt. We are also long term cautious on property due to oversupply in tier 3 and below cities. In the sector review, we also noticed that strong property unit sales in the first half is peaking, while stable property prices and higher land/construction costs will ultimately hurt profit margin. As a result, the fund is over weighted in consumer, transportation (logistics related), information technology, selective capital goods (telecom equipment, agriculture machinery, railway machinery) and health care; it has zero holdings in bank and property, and underweighted in energy and materials. The short coming of this portfolio lies in the risk that monopoly sectors such as energy, telecom services and banks perform in the near future, but we believe that in a one to three-year time window, the stronger bet lies in the midcap companies which should out-perform the index by a big margin.

Our view in the past three years that China clean technology, energy savings and industrial automation and services will benefit from government investment has become the market consensus. While we still like those industries, we will pay closer attention to the stock valuations.

Sector exposure chart:



Performance Attribution

Our stock selection in consumer, healthcare and energy sectors contributed to the performance positively, and our sector allocation added positive to relative performance by overweighting in consumer, information technology and healthcare sectors and underweighting in energy and financials sector.

Chinese Economy Outlook

- There is no major change in our view said in the first quarter outlook. Our expectations in the past have started to surface more prominently.
- Stimulating the economy to achieve targeted high GDP growth is not the priority for the new administration at this stage. Before formulating a long term economic policy, they need to clean up a few major issues (such as corruption, over capacity, misallocation of resources, etc) that had carried over from the last administration. Politically, it is better to have the problems showing up now than postpone fixing the problems at a later time. Premier Li wants to control the liquidity to put pressure on the over capacity industries to consolidate. Heaving said this, GDP is still very important for the economy to create jobs.
- We do not expect the government to help to improve the Liquidity in the near future. Year to date funds outstanding for foreign exchange increased by 1.58 trillion RMB (up 16.3% yoy). Total social financing increased by 3 trillion RMB (up 50% yoy). There is a mismatch problem in shadow banking system on the duration between long term assets and short term liabilities. The highest risk we need to closely watch for the next two quarters is the local government debt. The level of short duration debt at the local government financial platform that is linked to the shadow banking system is very high. Some of the borrowings will mature in the next two quarters and have to be rolled over. So the strategy is to control the liquidity and provide an environment for debt flow consolidation. June month end liquidity problem at the interbank repo market can be viewed as a stress test by the central bank (borrowing this seasonal funds flow need opportunity) and can be interpreted as a warning to the banks that they should deleverage their balance sheet, including off balance sheet businesses. Loan growth is not a priority for them now.
- On a Fundamental level, the economy is not improving that much. Inventories are still at high levels for industries such as steel, coal and retailers. The cash situation is not improving for most industries due to high inventory and receivable days and even high capex (carried over, even already scaled back). For all the A share listed companies, total Free Cash Flow in 1Q2013 dropped by 75.6% yoy and total Operating Cash Flow decreased by 57.4% yoy. We expect that the broad industrial inventory will start to see improvement toward the later part of the third and fourth quarter.

- We do not expect the financial system to collapse. Chinese central bank has capability and room to provide liquidity, of which one way is to reduce RRR. One 0.5% RR cut could release 500bn RMB liquidity. Now RRR is 20%, vs. 15.5% in 2008. Another positive point is that the Chinese households do not have a high financial leverage.
- We expect the equity market momentum to start to turn positive as the inventory situation starts to improve, the financial system risk concerns are reduced and very importantly, as the valuation on stocks get more attractive. For the China A shares, current price earnings ratio relative to growth is at the level we saw in 2008, after we adjusted growth estimates. We should see corporate earnings becoming less negative on a year on year basis in the fourth quarter.