Bin Yuan Capital China Equity Strategy – Second Quarter 2015

China Market Review and Performance Attribution (H share only, A share is available upon request)

The economy remained weak with HSBC PMI number still below 50. Power consumption and property sales have not recovered. Both of the H and A market experienced roller coaster type volatility in the second quarter of 2015. H share market had strong run of 16.7% in Apr, followed by a correction of 10.67% in May and June combined. A share market continued the strength with 19.5% return combined in Apr and May, and then fell by 7.6% in June.

For our H portfolio, positive contributors in second quarter were information technology, consumer discretionary and industrials. Some of our holdings in software, power equipment, logistics and defense continued to outperform.

One A share media name has lagged during this quarter. The share price dropped with A share market in June. We think the company is well positioned to become a platform in home entertainment and education center in the future. In possession of license granted by government and strong content support by its parent, the company is also actively seeking development in national channels. We believe the company is entering into fast growing period in the next few years.

China Economy Outlook and Portfolio Positioning

<u>Economy outlook</u>

As we discussed in previous letters, with low return of assets and high cost of liabilities, balance sheet of China is not healthy and efficient. The key initiatives to reverse the unfavorable situation are pro-market driven capital allocation, SOE reform and RMB internationalization.

Pro-market driven capital allocation

Indirect financing from the banking system played a key role in China in the past decades. However, with regulated NIM and distorted risk adjusted pricing, banks were reluctant to lend to SMEs who need capital for higher return investments. The stock market system is viewed as a more efficient way to allocate financial resources compared with the traditional banking system. We have recently seen the liquidity directed to the stock market and some innovative companies.

However, the leverage of speculative investors has increased very fast in the past few months, which has pushed the stock market to a bubble level and posed a threat to the function of capital market. The scale of non-broker entities that provide liquidity to investors has risen to a significantly high level without rigid risk control. To ensure the healthiness of stock market, government then started to tighten the irrational margin borrowing and umbrella trust in the second quarter, which resulted in dramatic correction of A share market in second half of June, and in turn affected H share market in a negative way. Over-valued GEM board has been over-bought in the past, and some of buyers were using high leverage, which exaggerated the sell down.

We were very concerned on the market uprush in early Jun, so we have profit taken some of our holdings and have raised cash to the maximum permitted level. We believe the market pull back helps to digest the price bubble. We hope to see the regulator to make effort to improve regulatory rules and risk control system. With that, the capital market could function better to channel resources to innovative companies that create value over time.

SOE reform

Without staff incentives, SOEs were lack of productivity in the past. The recent share price correction indeed provides a great opportunity for SOEs to launch stock incentive plan, which helps to align interest of management with the company.

Transferring some of SOE stakes to National Social Security Fund (NSSF) is such a good way to reduce social burden in the long term. It will soon become feasible after SOEs' holding entities use group assets injection to increase stakes in listed companies and retain their controlling ownership position. The cost of NSSF will be attractive after market correction and will benefit all the citizens.

RMB internationalization

"One Belt and One Road" and Asian Infrastructure Investment Bank (AIIB) will support China to further liberalize RMB and increase its competitive advantage in international markets. To achieve this goal, the government will as expected open up capital market gradually. Long awaited Shenzhen-Hong Kong connect makes sense in this regard.

Cross market opportunities

The valuation gap between A shares and H shares went to a more extreme level after recent correction as H share market was more volatile without the limit down mechanism. Table 1 and 2 has shown the valuation comparison among two markets by boards and by sectors as of July 7th (current year PE and last year PB). We don't have GEM board stocks in neither of our A share and Greater China portfolio as its valuation is difficult to justify.

We are selectively picking the best names of long-term themes and continue to screen out mispriced stocks.

Table 1:

	PE	**PB**
China A Share	26.75	3.64
Shanghai Mainboard	15.95	2.35
Shenzhen Mainboard	37.75	5.29
Small and Medium Board	43.38	6.21
GEM Board	65.66	9.47
China H Share	11.14	2.86

Table 2:

	A PE	A PB	H PE	H PB
Consumer Discretionary	33.23	3.57	12.36	2.50
Consumer Staples	25.48	4.93	20.33	4.27
Energy	28.16	2.02	16.11	0.94
Financials	12.22	2.37	8.51	1.38
Health Care	33.88	7.35	21.00	3.94
Industrials	33.58	3.66	14.87	1.77
Information Technology	48.17	7.66	18.08	3.94

Materials	46.00	3.76	10.66	1.29
Telecommunication Services	36.10	3.12	14.12	2.19
Utilities	21.02	3.12	14.10	2.31

The SH-HK Through Train has given Bin Yuan a good opportunity to select investments across exchanges. Combined with potential RQFII and Shenzhen-HK connect, the fund will be participating more in finding discounted pricing opportunities among stocks in different exchanges. At this moment, Hong Kong stock exchange with cheaper valuation becomes very attractive to mainland investors.

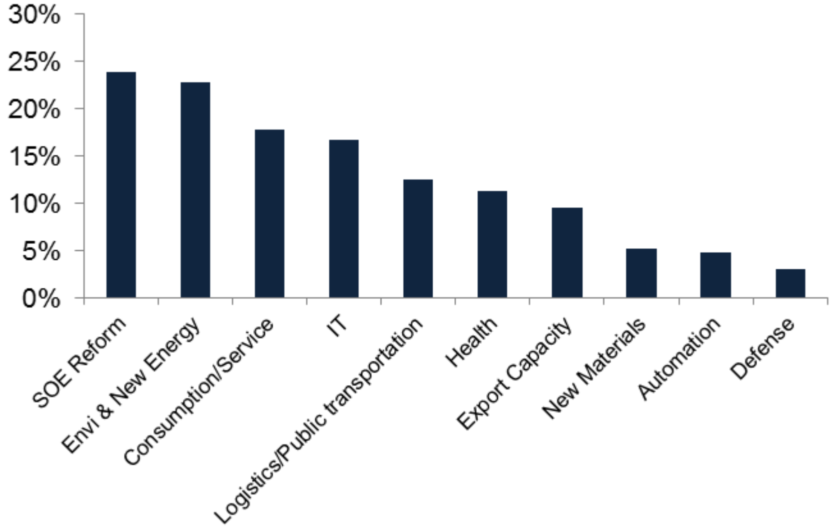
How we position in investments

Chinese economy is undergoing structural changes and the future growth will be gradually driven by efficiency improvement instead of volume expansion. The themes we identified to be benefit include global competitive capacity, automation, security, logistics, SOE reform, higher quality of life in terms of healthcare and clean environment, etc, of which we believe the earnings growth is visible and sustainable in the next few years:

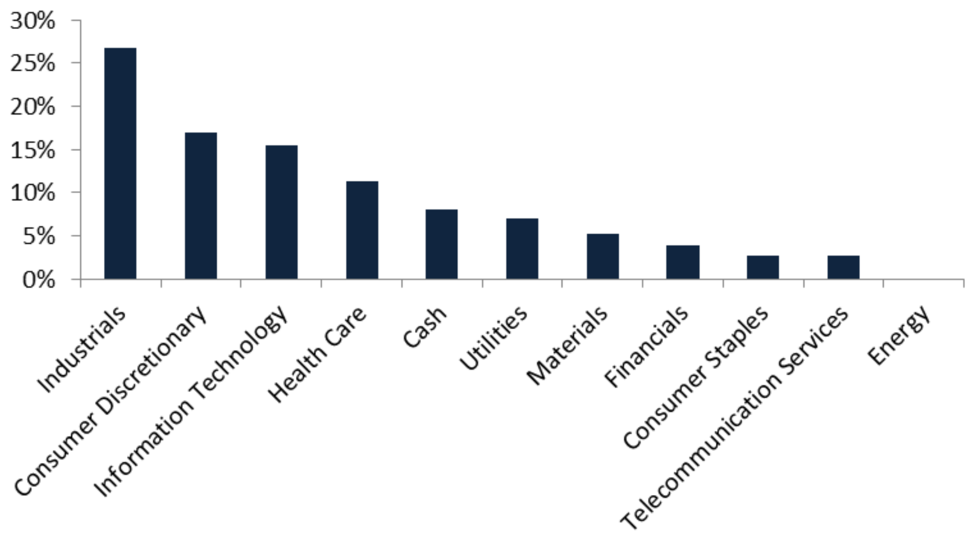
- Environment protection and new energy
- Power equipment and automation
- Information technology
- Logistics
- Healthcare
- Consumer staples
- Tourism and entertainment

Our portfolio exposure is as below, and our focus will still be on identifying long-term themes and stock selection.

By theme:



By sector:



Sincerely,

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