Bin Yuan Capital China Equity Strategy – Fourth Quarter 2015

China Market Review and Performance Attribution

After the big market corrections in both China A share and Hong Kong market during the third quarter, China has lowered interest rate and required reserve ratio to provide liquidity. Combined with the inclusion of RMB into SDR in November, the sentiment of stock markets has improved. China A share market recorded a gain of 16.5% and China H market was up by 4% in the fourth quarter.

The sentiment of market was also spurred by the buying activities of insurance companies during this quarter. The weak manufacturing sector and the reduction of the return on fixed asset investments have made capital leaving those slowing sectors and chasing for higher expected return asset classes. The highly liquid financial assets with relatively higher expected return have attracted this capital. In the fourth quarter, some of the insurance companies aggressively allocate cash to stock market, and as a result, some of the property stocks were elevated. We are cautious on this movement, especially the behaviors of blindly chasing those stocks. This poorly regulated insurance sector is concerning as some stock purchasing activities by those insurance companies are clearly a sign of mismanagement of assets and liabilities.

For our H portfolio, top contributors in the fourth quarter were logistics and consumer discretionary. New energy and some healthcare names lagged during the period.

We added a pharmaceutical enterprise on share price weakness. Its core fertility products are beneficiary of the favorable population policies. In recent years, the company implemented the strategic transformation of R&D, focusing on specialty chemical drugs, antibody medicines and IVDs. We like its strong pipeline and attractive segment positioning and the company will deliver robust earnings growth in the coming years.

China Outlook

The Chinese economy growth has continuously decelerated in the fourth quarter and the whole year of 2015. In sum, the long term fundamental structural issues, as we have repeatedly discussed in the past, are as follows: financial resources misallocation, capital duration mismatch, overcapacity in fixed asset based sectors and overvalued currency.

We still believe that the current government leadership is supportive in pro market reform. The government has been working hard to keep the economy on the targeted growth track, at the same time, is trying to resolve some of the above mentioned structural issues which are much longer term tasks. In short term the most significant concern is to deal with the overvalued RMB.

RMB devaluation

RMB has devalued since last August and it has caused stock market concerns. In the near term, the volatility of the equity market will stay high in the period during which RMB seeking for its equilibrium against U.S. Dollar. The Chinese economy is much bigger today compare to the one a few years ago and has much larger impact on the global economy. The movement of the RMB has drawn attention in the global marketplaces.

We believe that the weaker RMB is positive for China. We indicated in early 2014 that the strong RMB was harming the Chinese economy. We are not sure that what exactly the exchange rate will be in the near future, but exchange rate of USDCNY at 7.5 will improve China economy competitiveness significantly.

The other positive effect brought by currency depreciation for China is the economy phasing out of excess capacity. RMB has been appreciated against other currencies, not just USD, and depreciated against its domestic assets. The over valued RMB has decreased its competitiveness and made the domestic assets overpriced. On one hand, Chinese capital has been buying overseas assets and consumers have been spending their savings abroad. Domestically, on the other hand, the local currency has been worth less against the local assets which illustrates that the true underlining inflation had been much higher than reported figures in the past years. Thus the management of interest rate and inflation is distorted. The large government business enterprises enjoying much of the financial resources have made Chinese economy effectively running at a negative interest rate situation. The private sector, however, has borne much higher financing costs. This situation not only resulted in waste of financial resources but also made the interest rate cut less effective to stimulate the economic growth.

In an accelerated growth economy, stronger currency will help to reduce import cost, but in a growth decelerated economy, weaker currency would help to clean up some redundant domestic capacity. The weaker RMB can help the currency to better match domestic productivity and asset value. In addition to improvement of external competitiveness, the weak currency will force less competitive and oversupplied infrastructure-based capacity to consolidate.

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So we view the devaluation as positive. We believe that the central bank has realized that it is behind the curve to devalue the currency. It is not publicly stated, but the action reflected it is. The cost of maintaining high value RMB is very high as the market has priced in the RMB devaluation. The speed of the devaluation, as we expect, will continue to be faster than the market expected. Having said that, the central bank will use their still high foreign currency reserve to guild the movement of RMB in, they believe, China's favor.

The RMB concern should be reduced in second half of 2016. With a weaker currency, China will be better than most of other emerging economies as it is much bigger and more competitive with many high quality companies. A devalued RMB is not beneficial to other emerging economies. The panic and the volatility caused by RMB devaluation will provide buying opportunities in the next few months. Valuation is also getting very attractive.

Capital re-allocation

There has been a capital allocation imbalance between manufacturing and services. The export and fixed asset investment led growth have not only made China the second largest economy, made Chinese much wealthier, they also caused over-building manufacturing capacity and under-investing in service sectors. When the Chinese are getting wealthier, the quality of living, healthiness and happiness, will become the major pursuits. The eagerness for clean environment and leisure services will be increasing over time.

Supply side reform has been incorporated as one of the most important initiatives in the new five-year plan. The reform is not only intended to phase out excessive low end manufacturing capacity, but it also aims at allocating resources to higher value added products and services.

The proportion of service component in the CPI reported is much lower than our observations. The actual increase of cost of living, including housing, has been much higher and not fully factored into the CPI number. The distortion of the true inflation versus interest rate has led to excessive investment in some of the infrastructure related segments; on the other hand, service segments are under penetrated to meet the increasing consumer demand needs. Skilled labor in service sectors are in short supply. With the supply side reform, capital, labor and technology will be directed to innovative goods and services which will help to improve the quality of living.

Portfolio positioning

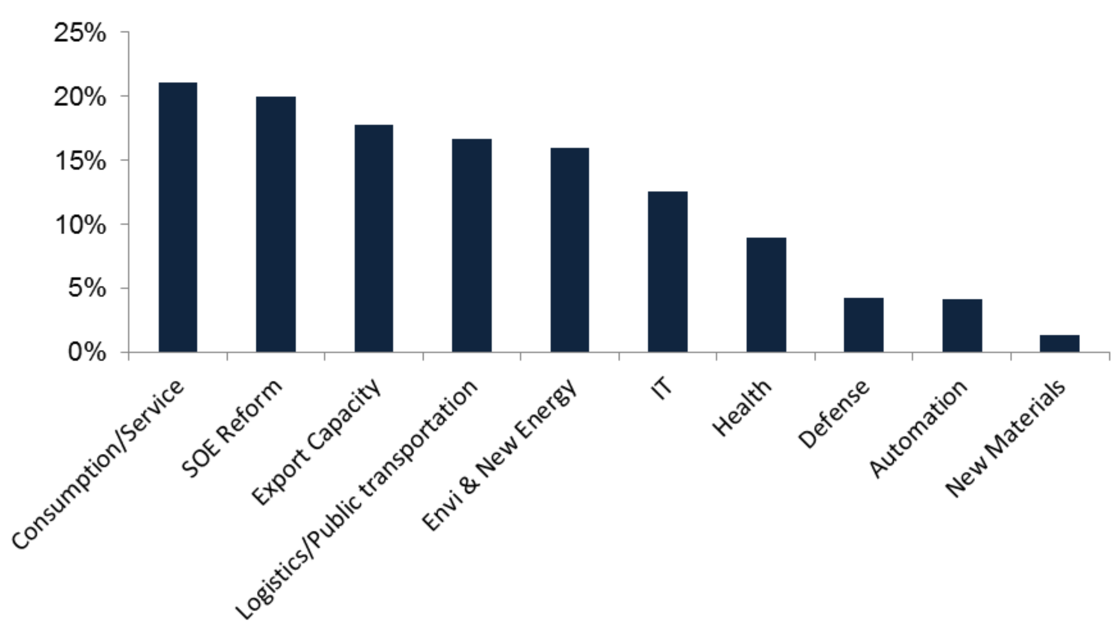
Our portfolio positioning is consistent with the structural trends we identified for mid to long term. The opportunities we target to focus on include:

➢ Adult education for professional services

- Leisure services including entertainment and tourism...etc.
- After market services of all sectors
- 2B internet and smart internet of things
- Globally competitive capital goods and services
- Environmental protection and new energy
- Logistics and public transportation
- Security and surveillance systems
- Healthcare products and services

The portfolio has avoided the speculatively buying stocks without real fundamental support. The capital that left from the manufacturing sector has been aggressively seeking higher return financial assets. The mismanagement of leverage and durations, assets and liabilities are the risks we need to pay special attention to. We are continuing cautious on those names whose growths are driven by non-disciplined merger and acquisition. As discussed in the newsletter of last quarter, the potential write-off of goodwill will ultimately dilute equity value of some speculative stocks.

Our portfolio exposure by theme for Greater China strategy is as below:



Sincerely,

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