



October 2017 China Insights Letter

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We strongly believe that China's market inefficiencies offer attractive opportunities for consistent excess returns. Compared to developed markets, the opportunity set available in China to generate alpha is greater. This is due to the Chinese market's large proportion of retail investors and misbehaviors of key market stakeholders that results in market inefficiencies. The key market stakeholders in China are investors, speculators, listed companies, and regulators. The misbehaviors that are the source of market inefficiencies and of excess return can be defined as cognitive and behavioral biases as well as intentional misbehaviors.

In this month's China Insights letter we focus on earnings misreporting by listed companies and how this type of intentional behavior can be exploited to generate excess returns.

China's ROE distribution curve provides evidence of earnings misreporting by publically listed companies

The distribution of listed companies' return on equity (ROE) in theory should **roughly** resemble a normal distribution* as seen in the case of publically listed companies in the United States.

However, in China there is a noticeable kink in the ROE distribution around 0%-6% (See Page 2). This higher than normal frequency suggests earnings misreporting by publically listed companies in China.

Regulatory structure, the IPO and delisting process, and investor preferences explain the ROE distribution abnormalities

To understand the motivation behind listed company earnings manipulation one must have a better understanding of the unique characteristics of China's regulatory structure and local investor preferences.

There are several elements of China's regulatory policy that provide strong motivation for listed companies to misreport earnings: 1) companies that report three consecutive years of negative earnings are delisted; 2) the penalties for earnings manipulation are relatively light; 3) a regulatory vetting process for IPOs has created a "Shell Value" for publically listed companies that often exceeds the penalties for financial fraud; and 4) "Shell Value" in some cases can make companies attractive M&A targets. The combination of these elements has provided strong motivation for listed companies inflate earnings.

Dr. Jason Jiang, Portfolio Manager

From an investor preference perspective, a strong emphasis placed on current earnings relative to future growth provides motivation for listed companies to exaggerate earnings. Where as in the US a company like Tesla can report negative earnings and still stay in favor with retail and institutional investors due to growth potential, Chinese retail investors are far less forgiving of loss making companies.

Over time we have seen the ROE distribution slowly moving towards a more normal distribution. A potential explanation for normalization is that as China's markets continue to slowly integrate with global capital markets, as domestic regulators and investors continue efforts to promote accurate financial reporting, and as investor preferences and time horizon change the frequency of misreporting has decreased.

That being said, we still find an abnormally high number of companies penalized for earnings fraud often found to have an ROE that is either slightly negative or slightly positive, within a range of 0 to 6% ROE.

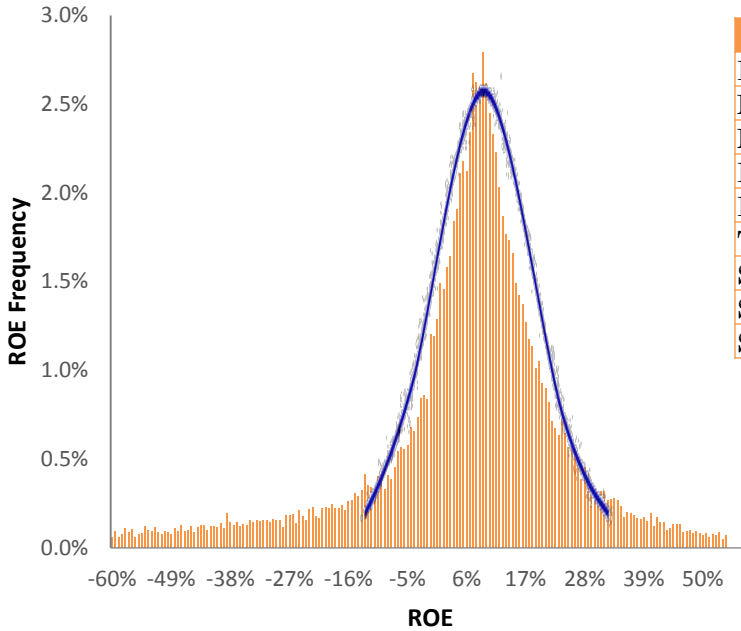
Generating alpha from listed company misbehavior

The first step in an approach to generate excess return from the misbehavior described above could be to hone in on the 0% to 6% ROE range where misbehavior seems most likely. In the second step, conditioning factors could be applied to better identify which companies are indicating a high likelihood of earnings manipulation. Even though effective methods to short individual stocks in Mainland China are lacking, identifying which stocks should be shorted is a useful exercise as purely avoiding the selection of these shares in certain market environments can result in excess return.

* Regardless of exchange location, the IPO process is not completely random, therefore ROE will not exactly follow a normal distribution.

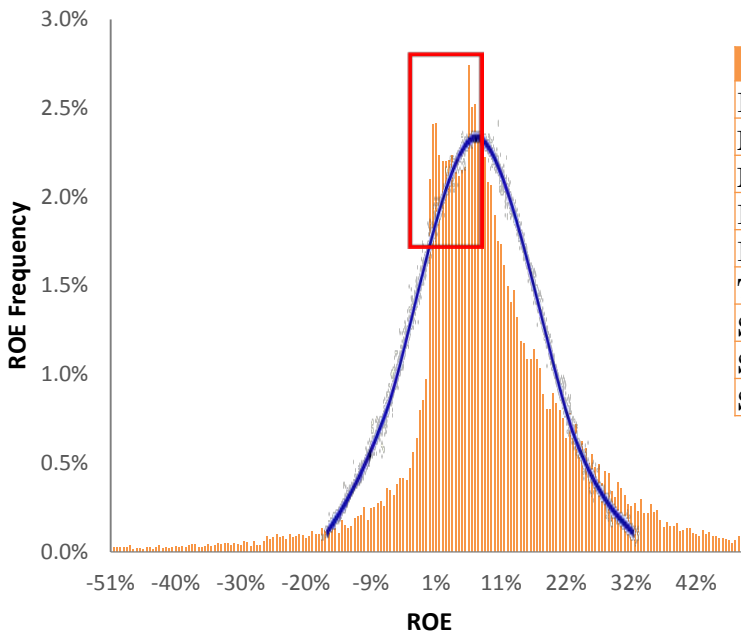


ROE Distribution of US Public Companies from 2000 to 2016



| Indicator | 2000-2016 |
|--------------------|-------------|
| Population | 43,041 |
| Max | 43,877,300% |
| Min | -115,582% |
| Population Average | 1,048% |
| Population Std | 211,510% |
| Threshold | [-60%,60%] |
| Sample | 37,621 |
| Sample Mean | 6.84% |
| Sample Std | 18.43% |

ROE Distribution of A Share Public Companies from 2000 to 2016

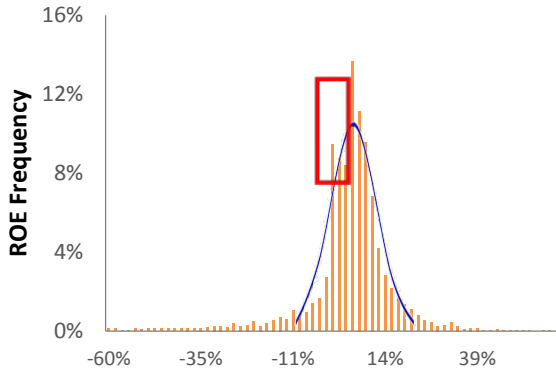


| Indicator | 2000-2016 |
|--------------------|------------|
| Population | 38,252 |
| Max | 2,644% |
| Min | -5,675% |
| Population Average | 6.89% |
| Population Std | 73.18% |
| Threshold | [-60%,60%] |
| Sample | 37,540 |
| Sample Mean | 9.43% |
| Sample Std | 13.96% |

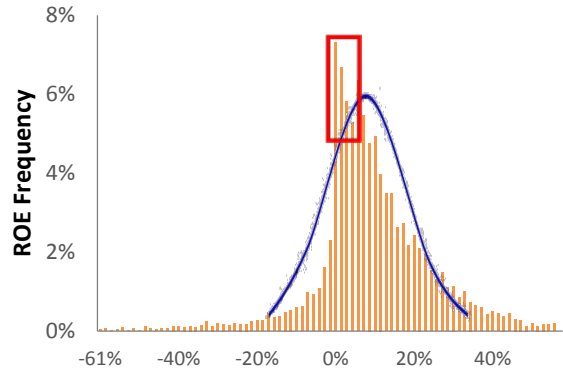


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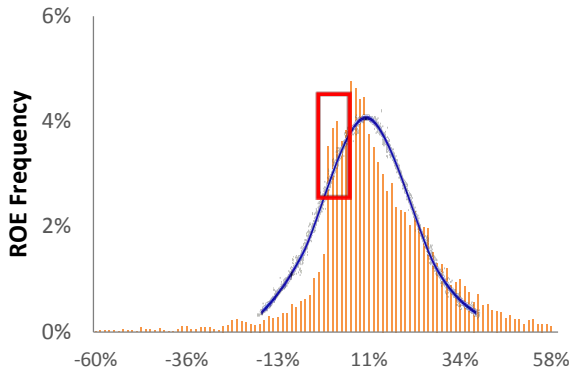
ROE Distribution Changes of A Share Public Companies from 2000 to 2016



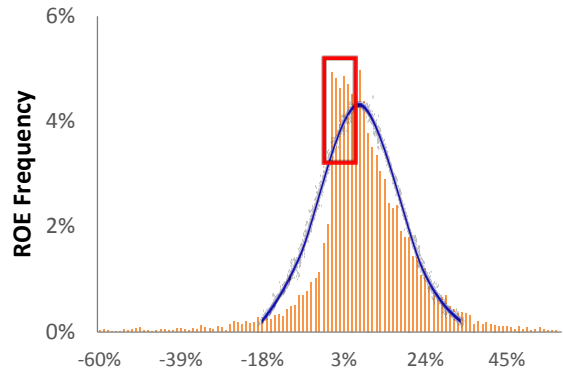
**ROE
2000-2003**



**ROE
2004-2007**



**ROE
2008-2011**



**ROE
2012-2015**

ROE of A Share Public Companies Penalized for Financial Fraud from 2010 to 2016

| No. | Ticker | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|-----|-----------|---------|---------|---------|---------|---------|---------|---------|
| 1 | 000611.SZ | 3.71% | 0.59% | -0.88% | -0.56% | -8.61% | -95.31% | -24.11% |
| 2 | 000691.SZ | -5.35% | 3.12% | 1.13% | 1.80% | -14.32% | 2.13% | 2.37% |
| 3 | 002200.SZ | 1.80% | -13.18% | -4.23% | -7.58% | 0.91% | 2.20% | -0.08% |
| 4 | 002569.SZ | 22.55% | 13.12% | 6.58% | 0.36% | -19.62% | -4.72% | -4.32% |
| 5 | 002679.SZ | 24.91% | 20.93% | 10.72% | 5.34% | 3.08% | 1.45% | 0.06% |
| 6 | 300028.SZ | 6.73% | 6.59% | 5.89% | -18.43% | -3.06% | -37.68% | -9.68% |
| 7 | 300277.SZ | 32.80% | 11.00% | 6.62% | 0.56% | -9.33% | 1.09% | -0.21% |
| 8 | 300372.SZ | 22.88% | 18.41% | 16.07% | 13.14% | 7.04% | -0.02% | -18.28% |
| 9 | 600250.SH | -14.56% | -64.17% | -39.98% | -31.83% | -9.86% | -21.54% | 3.70% |
| 10 | 600281.SH | -26.42% | -13.97% | -6.02% | -35.75% | -5.44% | -13.10% | -8.40% |
| 11 | 600467.SH | 10.36% | 9.84% | 7.14% | 2.63% | 0.22% | 0.13% | 1.11% |
| 12 | 600575.SH | 0.64% | 12.05% | 4.14% | 0.56% | -49.23% | 3.23% | 4.99% |
| 13 | 600598.SH | 5.88% | 4.88% | -3.07% | -6.32% | 3.96% | 11.94% | 13.02% |
| 14 | 601558.SH | 76.44% | 4.40% | -5.05% | -25.75% | -10.11% | -51.87% | -88.92% |



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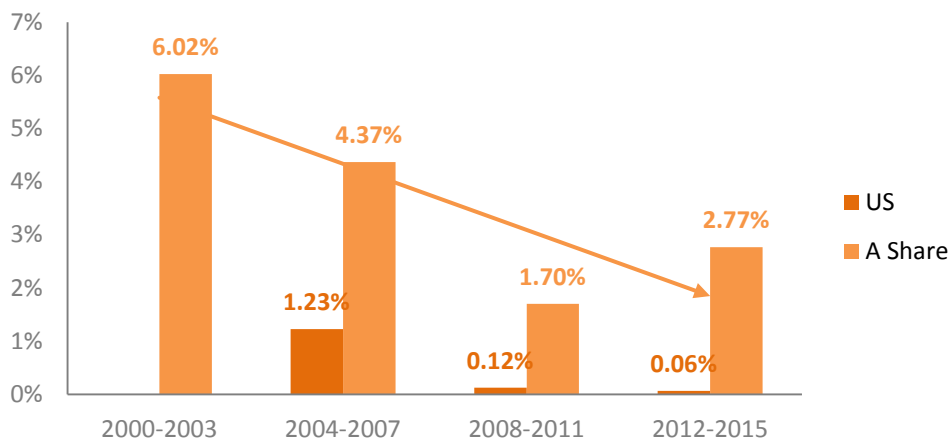
Distribution Changes of US Public Companies from 2000 to 2016

| Indicators | 2000-2003 | 2004-2007 | 2008-2011 | 2012-2015 | 2016 | 2000-2016 |
|-------------------------------|---------------|--------------|--------------|--------------|--------------|--------------|
| Threshold | [-60%,60%] | [-60%,60%] | [-60%,60%] | [-60%,60%] | [-60%,60%] | [-60%,60%] |
| Sample Size | 61 | 5,797 | 12,253 | 15,488 | 4,022 | 37,621 |
| Left Size of 0% | 3 | 134 | 283 | 291 | 166 | 127 |
| Size of 0% | 32 | 143 | 356 | 380 | 223 | 119 |
| Right Size of 0% | 22 | 223 | 414 | 459 | 255 | 151 |
| Left Frequency of 0% (a) | 4.92% | 2.31% | 2.31% | 1.88% | 4.13% | 0.34% |
| Frequency 0% (b) | 52.46% | 2.47% | 2.91% | 2.46% | 5.55% | 0.32% |
| Left Frequency of 0%(c) | 36.07% | 3.85% | 3.38% | 2.97% | 6.34% | 0.40% |
| Left Change (d= a-b) | 47.54% | 0.16% | 0.60% | 0.58% | 1.42% | 0.02% |
| Right Change (e= c-b) | 16.39% | 1.38% | 0.47% | 0.51% | 0.80% | 0.09% |
| Change Distance(d-e) | 31.15% | 1.23% | 0.12% | 0.06% | 0.62% | 0.06% |

Distribution Changes of A Share Public Companies from 2000 to 2016

| Indicators | 2000-2003 | 2004-2007 | 2008-2011 | 2012-2015 | 2016 | 2000-2016 |
|-------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Threshold | [-60%,60%] | [-60%,60%] | [-60%,60%] | [-60%,60%] | [-60%,60%] | [-60%,60%] |
| Sample Size | 4,449 | 6,748 | 10,276 | 12,835 | 3,232 | 37,540 |
| Left Size of 0% | 121 | 155 | 152 | 263 | 145 | 361 |
| Size of 0% | 421 | 492 | 362 | 633 | 339 | 779 |
| Right Size of 0% | 389 | 449 | 397 | 618 | 361 | 895 |
| Left Frequency of 0% (a) | 2.72% | 2.30% | 1.48% | 2.05% | 4.49% | 0.97% |
| Frequency 0% (b) | 9.46% | 7.31% | 3.53% | 4.93% | 10.49% | 2.10% |
| Right Frequency of 0%(c) | 8.74% | 6.67% | 3.87% | 4.82% | 11.17% | 2.41% |
| Left Change (d= a-b) | 6.74% | 5.01% | 2.05% | 2.88% | 6.00% | 1.13% |
| Right Change (e= c-b) | 0.72% | 0.64% | 0.34% | 0.12% | 0.68% | 0.31% |
| Change Distance(d-e) | 6.02% | 4.37% | 1.70% | 2.77% | 5.32% | 0.81% |

A Share Public Companies ROE Distribution Moving Closer to Normal Distribution (2000 to 2016)





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