Invesco

The Dragon Code

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Investment Newsletter

China has been an over-achiever in many aspects over the past 20 years, including stunning economic growth and rapid capital market developments. The sheer size of the market, the future growth potential and its increasing prominence on the world's stage have brought China into the limelight for many investors around the world.

We are pleased to share our investment team's insights on a quarterly basis and to provide you with the keys to investing in China. With each issue, we include a topical piece and an interview with one of our investment professionals. In addition we provide an investment guide for opportunities. Enjoy your reading!

Meet our investment professional

Paul Chan,
Chief Investment Officer, Asia ex Japan

Biography

Paul Chan joined Invesco Hong Kong Limited in November 2001 as an Investment Director and Head of Hong Kong Pensions. He became the Chief Investment Officer, Asia ex Japan of Invesco Hong Kong in July 2007, leading the Asian Investment Team (based in Hong Kong and Taipei). Paul has about 20 years of experience covering the Hong Kong / China markets. He has previous work experience with Morgan Stanley Asset Management (Singapore) Limited and Merrill Lynch Asset Management (Hong Kong) Limited. Paul graduated from the University of Manitoba with a Bachelor degree in Economics. He is a holder of the Chartered Financial Analyst designation.

Consumer price index (CPI) of China has crept up again to 5.4% in March. Is inflation expected to peak soon?

China CPI reached its 32-month high mainly due to higher food costs (+11% year-on-year) and housing costs (+6.5%). We believe inflation will continue to be largely food-driven, as we see a recent spike in international soft commodity prices (e.g., soybean, wheat, corn, etc.). On a positive note, food inflation can be cushioned by strong state strategic reserves which can be released to stabilize prices. Short production cycles can also help to contain prices and supply shortfall. Guidance from government officials indicated that the recent drought has not damaged crop fields and that food supply should be stable considering China has had seven consecutive years of record harvests despite the numerous snowstorms, droughts and floods in recent years. We maintain our view that CPI is going to peak out sometime towards the end of the first half of 2011, with the declining M2 money supply a leading indicator since it has shown reliable correlation on a forward basis.

Reversing its weakness in 2010, China domestic A-shares have been some of the best performing markets regionally in the first quarter. What is your outlook for A-shares?

China's domestic A-shares, measured by the local CSI 300 index, rose 3.0% in the first quarter and outperformed their offshore peers and regional proxy. Year-to-date, we saw a mean reversion despite the widespread cautiousness amongst local institutions and the harsher-than-expected required reserve ratio hikes. On top of this, there was the stringent loan growth quota and interest rate rise. Recently, local equity funds' exposure remained stable and is unlikely to trim further as the monetary tightening is approaching its tail end. For instance, the latest 25 basis points interest rate hike on 5 April proved to be a non-event for the local equity market, with investors fully pricing in such moves. In fact, government officials are now more confident of China's inflation outlook and sequential easing of CPI in the second half 2011. Finally, valuation remains supportive compared to the historical standard. The CSI 300 index is currently trading at a price-to-earnings ratio of about 14 times on 2011 earnings. This is attractive, judging by historical standards. We do not expect any significant earnings risks.

The auto sector is continuing to draw favourable attention recently. What's your view on the recent development, in particular, after Japan's earthquake?

e are monitoring the auto industry closely, as auto manufacturing is dependent on specific components that are normally produced by Japan. The earthquake in Japan may create a potential shortage for Japanese cars temporarily. This should not create a severe impact on car dealerships, given that most of them have diversified stocks across various European car brands. Separately, the Chinese government's intention to control vehicle ownership for cities with populations of over 10 million, would create a negative sentiment for auto segments covering the mass market - with the exception of the luxury car segment, which may benefit from the so called "upgrade demand". At this stage, specific policies have not been finalized and confirmed. Having said that, once municipal governments adopt the car ownership policies over the next four to five years, we anticipate that consumers would shift towards luxury cars when the realization that they can only own one car starts to dawn on them. Currently, luxury car sales volumes account for only 6% of China's total passenger vehicle sales versus the 15% to 20% figures in developed markets such as the US and Europe.

China paves the way for renewable energy use

In the recently announced 12th Five-Year Plan, renewable energy has been one of the central themes and the most widely discussed topic on the agenda being repeatedly highlighted within the seven strategic initiatives. Unsurprisingly, relevant alternative energy related stocks soared, that is, until Japan's worst-ever earthquake shook the world to its core. In the short term, the spillover effects of the tragedy in Japan have disrupted the lives of thousands living near the epicentre, causing power outages and occasional blackouts. As a result, the incident has prompted many governments to review their nuclear energy programmes. The Chinese government is likewise at a crossroads. On 16 March, just days after the earthquake and radiation leak at the Fukushima power plants, the Chinese government suspended the approval process for new nuclear power plants and mandated the comprehensive safety checks on existing plants as well. The State Council also announced that it would review and adjust its medium-term plan on expanding the nuclear power sector by 2020. Compared to developed economies, China is still at the early stages of nuclear power development, and is far behind in terms of electricity generation through nuclear power. It accounts for merely 1.9% compared to the world average of 14%. A key advantage to this is that, riding on years of experience and current technologies, China's nuclear capacity in construction will be more technologically advanced than those of developed economies, where many reactors have been in operation for over 30 years. At present, China has 13 operating nuclear power reactors, plus a further 25 nuclear power reactors under construction. The forecast is for nuclear power capacity to grow at a compound annual growth rate of 23% from 2010 to 2020[1]. With China targeting to reduce its carbon emissions per unit gross domestic product (GDP) by 17%, as specifically addressed in the 12th Five-Year plan, the government is seeking to increase the use of new and alternative energy and reduce its reliance on coal-fired power, which currently accounts for approximately 75% of electricity capacity. While it remains to be seen if the expansion in nuclear capacity will be halted, China remains committed to stepping up its efforts in promoting the use of non-nuclear, environmentally friendly alternatives including solar, wind and hydro power. All of these alternative energy initiatives are poised to benefit from the tail wind of supportive measures from the government.

Wind – supportive measures: China already has numerous wind power related infrastructure projects in the pipeline, including plans to build six large wind power farms and another two in the coastal regions. Offshore wind farms are also under consideration. Supportive measures have been introduced to the sector in recent years, including exemption from enterprise income tax, value added tax refund (2008), a revamped tariff mechanism (2009), and mandatory purchase by grid companies as imposed by the Renewable Energy Law.

Solar – one of the largest solar power component makers: Previous guidance from the National Domestic Reform Commission and an update from the 12th Five-Year Plan indicate that China has aggressive expansion plans to meeting global standards on alternative energy use. China also possesses the competitive edge and scale for expansion, with China being one of the largest manufacturers of solar power components, including poly-silicon and solar cells. Supportive measures are similar to those seen in the wind power sector, with additional subsidies on material and component-based projects.

Hydro – world's largest hydroelectric power station: Already the largest hydroelectric power producer in the world, China is poised to increase its hydroelectric power usage to reduce carbon emissions. In fact, the Three Gorges Dam power plant at Yangtze River is already the world's largest hydroelectric power station. With hydro power being the least costly method of generating power compared to coal-fired and wind power, hydro power development is given a higher priority over its alternative energy counterparts.

Investment implications
With the Chinese government's mandate to increase the use of renewable energy, vast opportunities would be created across the alternative energy supply chain. For example, in China's wind power industries, which can be divided into the upstream (wind turbine component manufacturers), midstream (wind turbine manufacturers) and downstream (wind farm constructors or operators) sectors, we see various opportunities across the power equipment space.

For integrated energy producers with diversified power segments, research is warranted to identify their true value by understanding the business composition. With share prices of selected energy names getting hammered recently because of the prevailing weak sentiment, our view is that this may lead to relative value opportunities, and we shall use our bottom-up stock picking capabilities to explore the best opportunities.

1 Source: World Nuclear Association, Xinhua, Mirae Research, 12 April 2011

Doorway to China's growth

Local know-how is critical to understanding the marketplace and the companies in China. With the strong backing from our Chinese joint investment operation venture, Invesco's Hong Kong-based investment team is in a very good position to capitalise on the growth potential that this market has to offer.

Invesco PRC Equity Fund

Objective: The Fund aims to achieve long-term capital growth by investing in transferable securities of companies with substantial exposure to mainland China.

Universe: Hong Kong listed H shares, red chips and China plays, plus Shanghai and Shenzhen-listed A and B shares.

Fund managers: Samantha Ho (since November 2004) and Joseph Tang (since July 2007)

Invesco Greater China Equity Fund

Objective: The Fund aims to achieve long-term capital growth by investing in securities of Greater China markets.

Universe: Hong Kong stocks, Hong Kong listed H shares, red chips and China plays, Shanghai and Shenzhen-listed A and B shares, Taiwanese equities and Macau equities.

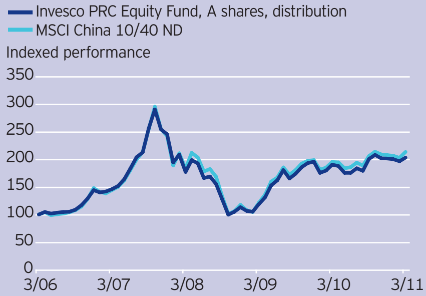
Fund manager: Mike Shiao (since 31 December 2006) and Samantha Ho (since November 2004)

Fund information at a glance

	Invesco PRC Equity Fund	Invesco Greater China Equity Fund
Launch date	October 1995	July 1992
Fund size	USD 2.06 billion	USD 604.5 million
Fund based currency	USD	USD
Reference index	MSCI China 10/40 ND*	MSCI Golden Dragon ND*
Domicile	Dublin	Luxembourg
Legal structure	Mutual Fund - Irish Unit Trust authorised as UCITS	Sub-fund of Invesco Funds, SICAV with UCITS status
Annual management fee	A: 2.00% C: 1.50%	A: 1.50% C: 1.00%
Minimum investment	A: USD1,500 C: USD250,000	A: USD1,500 C: USD250,000
Bloomberg code	A: INVPRDA ID C: INVPRDB ID	A: INVPGCI LX C: INVPGCC LX
S&P Fund Management Rating	AA	A
Morningstar Rating	★★★★	★★★

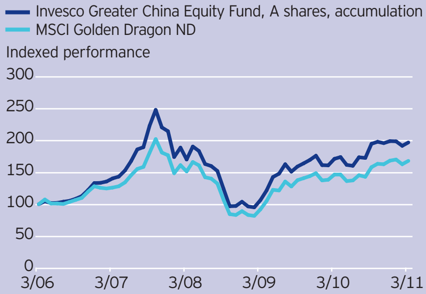
Sources: Invesco, Morningstar, Standard & Poor's, as at 31 March 2011.

Invesco PRC Equity Fund returns 102.8% over five years.



Source: Morningstar, NAV to NAV, in USD with dividend reinvested, as at 31 March 2011.
Past performance is not an indication of future performance, provides no guarantee for the future and is not constant over time.

Invesco Greater China Equity Fund returns 96.7% over five years.



Source: Morningstar, NAV to NAV, in USD with dividend reinvested, as at 31 March 2011.
Past performance is not an indication of future performance, provides no guarantee for the future and is not constant over time.

* Effective 1 January 2009, the reference index of the Invesco PRC Equity Fund was changed from MSCI China to MSCI China 10/40 ND.

Effective 1 April 2008, the reference index of the Invesco Greater China Equity Fund was changed from MSCI Zhong Hua to MSCI Golden Dragon ND.

All data is as at 31 March 2011, sourced from Invesco unless otherwise stated.

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