

Evolution of TIFF's Chinese Equities Investments

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Background

As many of our investors know, TIFF has had a material investment in Chinese equities for over five years. While our exposure has never been more than 15% of our equity portfolios, it has represented a larger percentage of our tracking error and overall risk over the past few years. As a result, we receive many questions about this part of our portfolio. Therefore, we thought it would be timely to provide a brief update on our positioning and thoughts on the market.

First, Principles: why did we invest in China in the first place?

China became a research priority for us in mid-2015 due to our observations that 1) its economy was growing quickly, and 2) the stock market (represented by the CSI 300 Index) declined over 40% in the two months ending in August 2015 and might represent good value. We spent almost two months in the country doing on-the-ground research, and we ultimately made multiple investments throughout 2016. We found the Chinese equity opportunity attractive for several reasons, including:

- a) Investing in China presented an unusual combination of many inefficiently priced businesses and very high liquidity. Usually, we find inefficiently priced securities in niche parts of the markets that are not liquid and do not support large investments. This situation was an exception.
- b) We perceived that institutional capital could do well in light of heavy retail participation – with roughly 75% of the trading volume being generated by retail investors. Institutional investors often have research advantages versus individuals.
- c) China was (and still is) underrepresented in the various global benchmarks compared to the percentage of global GDP. We felt that eventually, index vendors like MSCI and FTSE would adjust, and the subsequent inflow of passive capital would provide a tailwind. Additionally, not only was China underrepresented in various benchmarks but also many investors were underweight by even that modest index percent. We thought this dynamic could represent an ongoing bid as investors potentially added to their exposures and as China grew in terms of index representation.
- d) The onshore China stock market, partly because it can be complicated to access, exhibits a relatively low correlation to the US and other major markets. We believed that within the realm of equity opportunities, this investment would provide some valuable diversification for our portfolios.
- e) We found three outstanding partners who we felt had a high probability of outperforming their benchmarks. We debated whether it would be possible for the identified managers to outperform by 2-3% per year. Our most optimistic case was they might generate up to 6% alpha annually. To date, they have outperformed their benchmark since inception by 6.8% per year as of August 31, 2021.

2020 Adjustment

Between 2016 and 2020, our China investments exceeded our expectations. Over that period, the market nearly doubled, and our active investments there almost tripled. TIFF's China investments handily outperformed the S&P 500, one of the best performing major market indexes in this period. Despite this good outcome and our continued confidence in our manager partners, we decided to reduce the position

at the end of 2020 from 12-13% of equity portfolios to roughly 8% at year-end. Our decision to reduce our position was the result of several key observations:

- China was the first country to experience COVID and the first large economy to gain control over the spread of the virus. We have described this dynamic as "COVID FIFO" (first in, first out) in several meetings and letters. We felt that China's outperformance in 2020 reflected this development and other countries that were a bit further behind in the process were better places to deploy capital in 2021.
- We also worried that China's "zero tolerance" policy towards COVID outbreaks could, absent other material offsetting policy decisions, negatively impact the Chinese economy and stock market in the event of future outbreaks.

In addition to our macro-observations, many of the basic pillars of our original thesis have weakened slightly. MSCI has increased the onshore China weights in their various benchmarks, although we expect more to come. The China stock market has become more efficient in our view. Foreign investors' percentage ownership of Chinese equities has increased, and many of the various peers that we talk with seem more comfortable deploying capital there.

2021 Observations

Reducing our China position at the end of 2020 has been beneficial to our 2021 performance as the Chinese markets have underperformed ACWI by roughly 20% through August. However, this outcome is part skill and part luck. The skill we think was making the various observations discussed above and acting. The luck portion was reducing the position in advance of regulatory adjustments that have hurt the profitability of a variety of Chinese businesses and caused increased uncertainty. Examples include converting multiple education-focused businesses into nonprofits, applying banking regulations to non-traditional finance companies, cracking down on anti-competitive behaviors of several large tech businesses, forcing delivery businesses to guarantee minimum wage and offer social security to their workers, and implementing a three hour per week max on playing video games for minors. It is not clear whether these adjustments are good or bad over the long run. While maintaining a more equitable society could create a stronger, more durable economic expansion, many of these adjustments either limit revenue growth or increase expenses for some of China's largest companies.

Given the power that the Communist Party has in China, periods of regulatory adjustments are not new or surprising. We identified this issue as one of the major risk factors associated with investing in China in our original memos from 2016. However, the extent and speed of the reform in 2021 was a negative surprise that we did not expect. With the benefit of hindsight, we would have been better off reducing our position even more - at least in the short term.

Current Thinking

We continue to be overweight relative to our equity benchmark, the MSCI ACWI, but just not as much as in the past. China continues to experience higher growth and more attractive valuations than much of the rest of the world. We continue to expect our managers to be able to outperform their benchmarks. For example, while the Chinese markets have underperformed thus far in 2021, our managers on average have outperformed their benchmarks by over 450 bps through August – essentially right on track with the annual alpha we've experienced over time. While the correlations to other markets have increased as we

expected they would, they are still low in absolute terms. The trailing three-year correlation to the S&P 500 is only 0.60 versus 0.90 and 0.83 for Europe and Japan, respectively. China's path to becoming a major market and major player in the global economy has become clearer. We believe that we are heading toward a bipolar world with China as the major economy in the East and the US as the major economy in the West. We wouldn't have a global, forward-looking portfolio without material exposure to both markets. While the recent reforms have caused some mark-to-market losses, it is hard to argue that the new regulations are unreasonable public policy decisions. The Communist Party has a track record of making mostly good economic decisions. According to their statistics, they have not had a recession in over 40 years.

Finally, the recent bout of volatility and uncertainty may just be another case of conditions that play to the strengths of active management. For example, a potential default by Evergrande, a large Chinese property developer, has caught the market's attention over the past few days. While this is a fluid situation, based on discussions with some of our manager partners we think the Chinese government has the resources and the incentive to prevent an Evergrande restructuring from becoming a broader systemic problem. If our assumption is correct, we may look back on this period as an attractive entry point. Some of the businesses that we still find attractive are cheaper than they used to be.

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The specific types of assets that each manager holds will vary over time. The managers discussed above invest capital for one or more TIFF portfolios and do not invest on behalf of all TIFF portfolios. Both the aggregated manager return (which is net of fees) discussed above and the aggregated benchmark return discussed above are based on an equal weighting of returns by manager. The benchmark return is a blend of each manager's benchmark (in certain cases, the manager benchmark is itself a blended return). The relevant indices are the MSCI China Index (large and mid cap offshore Chinese stocks and large cap domestic Chinese stocks), the Shanghai Shenzhen CSI 300 Index (tracks the 300 largest and most liquid domestic Chinese stocks, or A-shares). ACWI is the MSCI All Country World Index (large cap stocks worldwide).

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