

A star fund manager specializing in Chinese small-cap stocks lays out the 3 key pillars driving the country's 'vicious cycle of innovation' — and shares the 3 sectors where she's finding long-term opportunities

Vicky Ge Huang

- Tiffany Hsiao is a manager at Artisan Partners where she will launch a China post-venture strategy.
- Hsiao has identified three key pillars that are driving “a vicious cycle of innovation” in China.
- She also shares three sector picks where she is finding long-term structural opportunities.

US stocks have been on an absolute tear since recovering from the coronavirus-induced market crash last March, so why should investors consider Chinese stocks now?

Tiffany Hsiao, a star portfolio manager at Artisan Partners who has spent the past 12 years investing in China, said the answer is both simple and complex.

Prior to joining Artisan last fall, Hsiao made her name at Matthews Asia where she ran the \$543.2 million Matthews China Small Companies fund, the \$248.5 million Matthews Asia Small Companies fund, and the \$2.4 billion Matthews Asia Innovators fund.

In March, she will launch a new strategy to invest in post-venture firms and private companies in China. The country's 2021 GDP is forecasted to grow 8% even after becoming the only major economy to report positive GDP growth in a coronavirus-ravaged 2020.

That is the simple answer to why investors should try to capture the “untapped alpha and uncorrelated growth” of the world's second largest economy, Hsiao said in a recent media briefing.

The more nuanced reason traces back to the fundamental and technical catalysts that are driving the Chinese stock market going forward.

Hsiao said she believes that fundamentally, China is on the cusp of “a vicious cycle of innovation,” which is further aided by the fact that “after years of capital reform, China's inefficient equity market, particularly the under-researched small- and mid-cap stocks, are ripe for institutionalization.”

'A vicious cycle of innovation' driven by three key pillars

Not too long ago, China was known as the world's factory due to its low labor costs, low taxes, and lack of regulatory oversight. But today, China reminds Hsiao of the Silicon Valley in the 1980s where she grew up witnessing the waves of innovations that directly improved daily life.

This cycle of innovation is first and foremost driven by a large pool of “patient capital” provided by long-term public and private investors in China, which will be a critical resource for



Artisan Partners

Tiffany Hsiao is a portfolio manager at Artisan Partners.

entrepreneurs to turn disruptive ideas into real-world applications.

“This is a key success factor for Silicon Valley since the 1980s, where generations of successful entrepreneurs invested in the next generation of innovators,” Hsiao said. “In China, after the first wave of successful wealth generation, these first-generation entrepreneurs are now investing in the next wave of innovators and providing patient capital.”

The increased scale of patient capital is in part illustrated by the explosive growth of China's private funding market, which has expanded at a 24% annualized rate for the past decade. The amount of private funding raised in China has grown almost nine-fold from a mere \$10 billion in 2009 to \$88 billion by 2019, according to Hsiao.

The second pillar of innovation is reflected in China's large and diverse consumer market.

Hsiao said one out of five Chinese households had a disposable

income of over \$25,000 as of 2019. Multiplying that purchasing power by 107 million Chinese households creates a consumer market even larger than the US’.

“We believe that there is plenty of room to grow and diversify in the Chinese consumer ecosystem,” she said. “With the robust physical and digital infrastructure in place, China’s consumers are ready to openly embrace an accelerated pace of innovation in products and services.”

The final pillar lies in the scale of China’s human capital, which has experienced explosive growth both domestically and by way of the return of overseas Chinese people.

Hsiao pointed to 1978 when there were only 18 Ph.D. students enrolled in China, but 40 years later, that number has reached nearly 400,000. She added that the combination of growing patient capital, a large and diverse market, and highly skilled domestic labor are now attracting overseas Chinese to return and pursue entrepreneurial ventures.

3 sectors ripe with innovators

When it comes to betting on innovators in China, many investors automatically think of the “BAT” tech trio – Baidu, Alibaba, and Tencent. However, these tech behemoths have long been put under the microscope of both domestic and international investors, leaving little untapped alpha for new investors.

Meanwhile, Chinese stocks remain under-covered by analysts, with only one-third of companies having more than one analyst rating, which means that 60% of the market is still undiscovered, Hsiao said, adding that most of these overlooked stocks are in the small- and mid-cap space.

“We believe the combination of a vicious cycle of innovation and increasingly institutional investor base will disproportionately benefit the under-researched small- and mid-cap companies in China, and create a new force in the market to help narrow structural inefficiencies,” she said.

In the US, innovation often takes place in the tech industry, and that’s sometimes the case in China too where Hsiao finds some

of the most attractive opportunities in the semiconductor sector, where she sees “a trillion-dollar ecosystem in the making.”

Despite the fact that China imports over \$300 billion of semiconductors per year, the Chinese semiconductor sector is benefiting from high barriers to entry due to design and manufacturing complexities, according to Hsiao.

Another area where innovations are mushrooming and opportunities are vast is the healthcare and biotech sector.

China’s healthcare spending is close to \$1 trillion a year, according to Hsiao. Given the massive population and large unmet needs, biotech companies that choose to target a specific area of treatment for Chinese patients are likely to be handsomely rewarded.

She used the treatment of lung cancer as an example. While cancer is essentially a mutation in your DNA, the ways that lung cancer happens to the Asian population and Caucasian populations are starkly different.

In China, 50% of lung cancer patients are identified as having EGFR mutations, whereas only 20% of such mutations are identified in the Caucasian population.

“So with those biological differences, a Chinese biotech company can easily say I want to target the largest cancer in China, I just have to go find an EGFR inhibitor or monoclonal antibody that targets that target,” she said in a recent interview. “So it was very low hanging fruit, and it’s very easy to identify where your opportunities are.”

With China’s goal of achieving carbon neutrality by 2060, the renewable energy sector is another area where Hsiao expects to find long-term structural opportunities.

“There are always pros and cons to every type of political design. In China, it’s a single-party regime, once the party has advised on something, everybody executes towards the same direction, so things get done a lot faster,” she said.

In the case of renewable energy, Hsiao expects to find innovative solutions not only in more traditional plays of electric vehicle makers but also companies supporting the whole manufacturing supply chain of EVs.

Tiffany Hsiao is the portfolio manager of the Artisan China Post-Venture Strategy. This article represents the views of Vicky Ge Huang of Business Insider and Tiffany Hsiao as of 22 Feb 2021, and those views and opinions presented are their own. Artisan Partners is not responsible for and cannot guarantee the accuracy or completeness of any statement in the discussion. Any forecasts contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation.

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