Chinese equities: an ongoing compelling story
Invesco China Focus Equity Fund

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"We continue to see many compelling bottom-up opportunities in China, driven by a strong domestic economy and rising digitalisation. Our fund has greatly benefited from these opportunities and delivered solid risk-adjusted returns."

China is a land rich in compelling bottom-up investment opportunities. This is based on our expectations that its domestic economy will emerge as a reliable driver of growth while the increasing digitalisation of Chinese society is opening up new markets which some companies are taking advantage of to enhance their product offerings. While selecting stocks, we favour private enterprises which demonstrate entrepreneurship and possess a notable track record in running businesses for their shareholders.

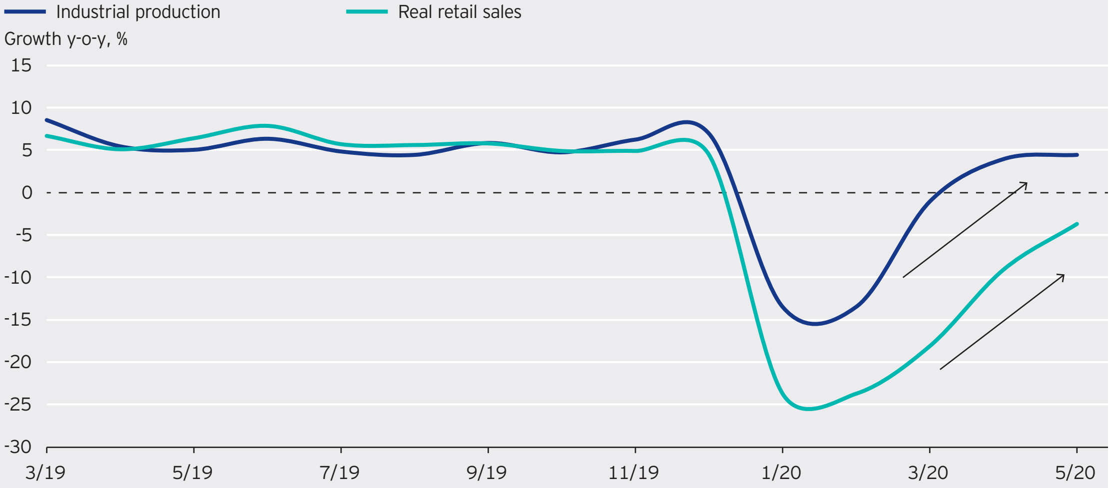
The Invesco China Focus Equity Fund is a flagship product managed by the Invesco Asia Equity Investment Team. The team has extensive local knowledge which supports the bottom-up stock selection process. This process has resulted in notable exposure to stocks reliant on the domestic economy which we believe have the potential to deliver sustainable returns. The fund has offered attractive risk-adjusted outperformance to clients against its benchmark MSCI China 10/40 Index across 1-, 3- and 5-year periods. Its recent performance has also been strong considering the heightened market volatility during the Covid-19 outbreak.

Higher earnings visibility and growth offered by domestic sectors

China's domestic sector has grown significantly and now constitutes a dominant share of GDP. We expect the domestic economy to stage a recovery following the disruption caused by Covid-19 and remain resilient due to several factors.

Firstly, China has imposed strict control measures to contain the outbreak and we believe the government has demonstrated its capability to manage the situation. Secondly, policy support is evident with lending rates and banks' reserve requirements being cut several times to enhance liquidity. At the same time, the budgetary fiscal deficit has increased and special Covid-19 government bonds will be issued to be used to boost infrastructure spend and employment. As such, domestic sectors such as industrial production and retail sales have been improving since March

Figure 1
Chinese economy is on the path to recovery



Source: NBS, Morgan Stanley Research, as at June 2020. Smoothed line.

(figure 1) and we expect them to gather momentum as economic activities normalises further.

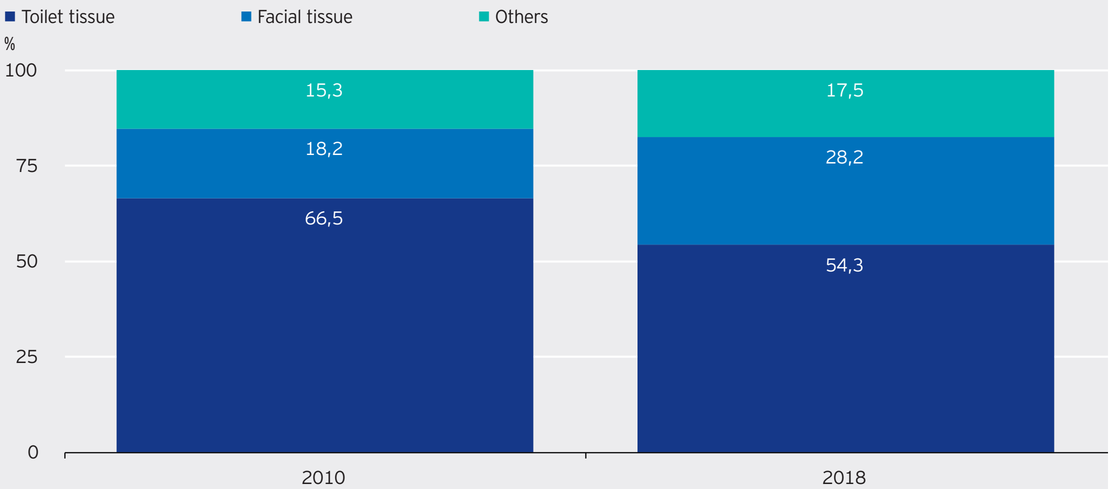
Escalating geopolitical risk led to a greater tilt towards consumer-related stocks
We have seen US-China tensions moving beyond trade to technology and finance, evidenced by US actions aimed at limiting Huawei's (China's largest telecommunication equipment manufacturer) access to semiconductor technology and a tightening of regulations surrounding US-listed Chinese companies. The Phrase 1 trade agreement[1] has helped to mitigate tensions somewhat, but we believe they will continue. In particular, we expect geopolitics will be a key risk that investors will closely monitor in the second half of 2020 as the US election approaches.

Domestically focused companies offer higher earnings visibility and growth
Given the strength of the domestic economy and continued geopolitical tensions, we have positioned the Invesco China Focus Equity Fund to capitalise on domestically focused companies, by selecting stocks benefiting from structural growth trends. We believe these stocks offer higher earnings visibility and growth, and will deliver sustained returns for investors.

Our analysts on the ground have noticed a strong increase in consumers' wealth which is driving up overall spend as well as demand for more high-end products. Since the latter can be sold at higher prices than lower-end products, some companies are improving their product offerings to meet this demand. This has led to our investment in a large tissue producer, a long term holding in the fund.

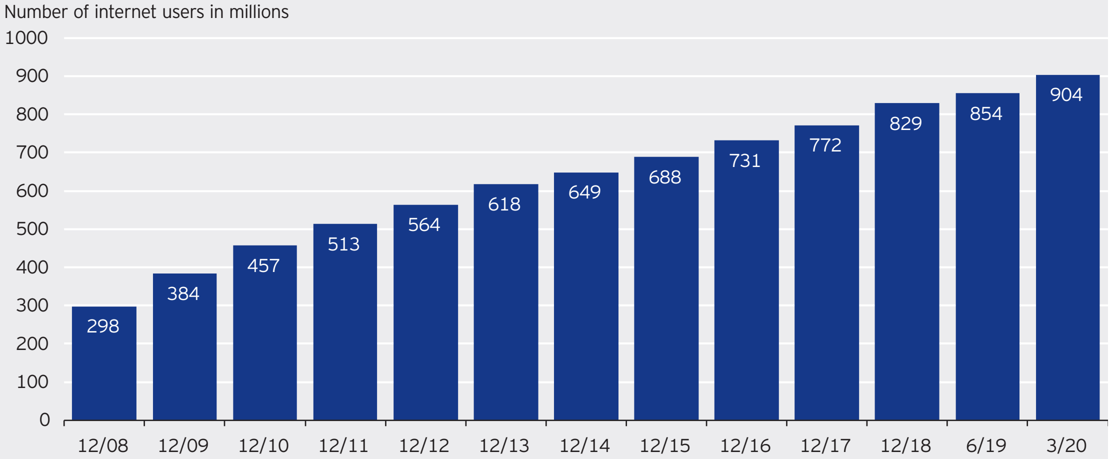
The company is moving its product mix towards mid-to-high end tissues and is doing so, within a growing market. The per capita tissue consumption in China has grown at a CAGR of 8% (2010-2018) versus global growth of 3%[2]. In particular, non-toilet tissues including facial tissues, as well as higher-end products have experienced rapid demand growth (CAGR of 13%) over the same period. Against this backdrop, the company has focused on facial tissues while continuing to launch higher quality toilet tissue products (figure 2). We believed that the company's valuation did not fully reflect its potential to deliver double-digit organic sales growth while maintaining a healthy margin, as it continued to position its business to benefit from this strong premiumisation trend.

Figure 2
China's tissue consumption volume mix



Source: China Household Paper Industry Association, Citi Research, as at October 2019.

Figure 3
Internet users in China have tripled in the past decade



Source: Statista, as at March 2020.

Digitalisation is opening up new value-added opportunities

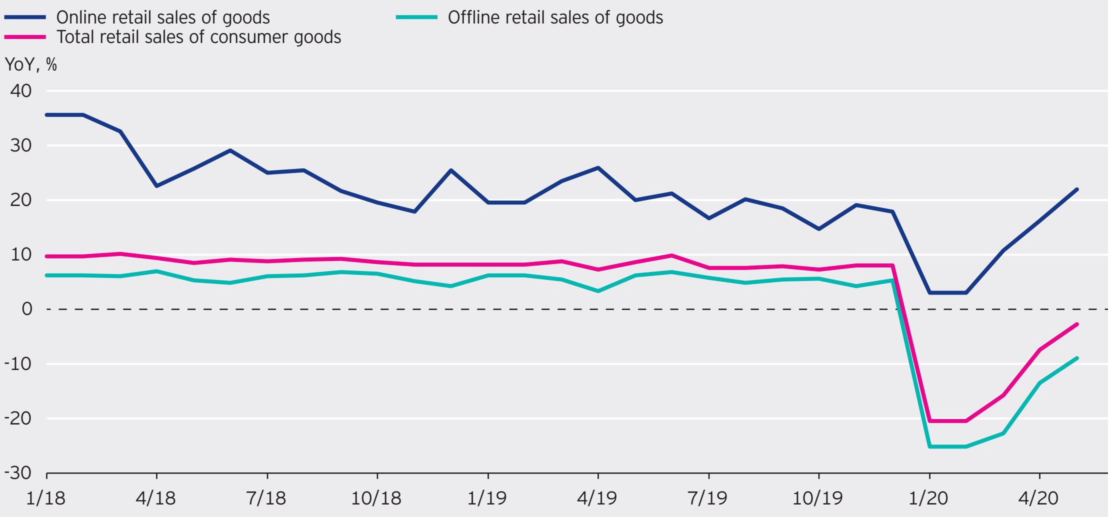
Digital trend is supported by improving infrastructure spend and innovative corporate strategies
Compared to five years ago, the average download speed of mobile broadband in China has increased by about six times while the fee for mobile internet (mobile phone users accounted for 99% of the internet users) has dropped by over 90 percent. A faster internet service at lower cost has greatly boosted usage growth. China is now a digital society with more than 900 million internet users (figure 3). It has pledged to invest more than US$3.78 trillion in new digital infrastructure over the next 5 years[3]. In 2020 alone, as much as US$423 billion has already been allocated to projects including 5G base stations, data centres and artificial intelligence.

The digital trend is very evident. A Chinese consumer's daily life involves frequent engagements with different types of online platforms offering both products and services. This has encouraged many internet companies to use innovative strategies to engage consumers. The importance of the digital trend can be seen in the MSCI China index composition where the communication services and consumer discretionary sectors constitute more than 20% of the index. The large companies in these sectors are mainly in the internet space.

A good example is our holding in an online platform which is capitalising on the growing digitalisation of consumer markets. Despite being a late comer to the food delivery market, the company gained market share from its competitors to become the number one platform for food delivery. Using this position, it has been successful in cross-selling higher-margin lifestyle services in leisure and entertainment.

Covid-19 has added fuel to the digital trend by opening up new opportunities
The Covid-19 outbreak is accelerating the digital trend by encouraging the purchasing of products and services on-line. E-commerce platforms acted fast to capitalise on this growth by launching a new shopping festival, Double Five, throughout which customers were provided with discounts and incentives to generate strong sales growth. The Covid-19 outbreak also encouraged other new strategies. For instance,

Figure 4
Resilience of e-commerce retail sales during Covid-19
Growth rate of online & offline sales of consumer goods



Source: NBS, Morgan Stanley Research as at 15 May 2020.

a leading internet conglomerate (a holding) introduced an international version of its cloud-based video conferencing tool in more than 100 countries to capture market share. These strategies resulted in the e-commerce retail sales growth remaining resilient during Covid-19 (figure 4).

The Covid-19 backdrop also led to the emergence of new markets such as the telemedicine market. During the crisis, e-commerce platforms, which had previously just delivered drugs or booked appointments, began to provide treatment and advice. For example: a subsidiary of our holding in a large online platform claimed that monthly consultations had grown tenfold since the outbreak: an arm of another large platform (a holding) launched a free "online clinic"; and WeDoctor, an app backed by a leading internet conglomerate (a holding) mobilised 20,000 physicians to work online during the epidemic thereby encouraging the use of its platform going forward.

A focus on private enterprises

Our investment strategy favours private enterprises. They are highly competitive and innovative, constantly utilising new technologies to deliver market leading products and services. We are positive about their growth as they continue to improve efficiency and productivity. From a corporate governance perspective, we believe that the interests of private enterprises are more aligned with our interests, as investors.

A private company that is moving online to stay relevant to customers
A good example that showcases private enterprises' agility is a long term holding in a hypermarket. As one of the largest hypermarkets, it's management reacts timely to capitalise on opportunities within its online operations, in our view. Following an investment by a leading e-commerce platform (late 2017), the company began a digital transformation that ensured that during Covid-19, the company achieved stable revenue thanks to its rising online presence. Meanwhile, we saw similar investment by this e-commerce platform in state-owned enterprises (SOEs) and changes are generally not as fast in these businesses.

Private enterprises are managed inline with investors' interests unlike many SOEs
In our view, private enterprises are more likely to manage their businesses in the interest of shareholders, and in doing so, take corporate governance seriously. Within our bottom-up stock selection process, we attach a high level of importance to ESG factors.

Our view has been reflected in our lack of exposure to a leading liquor producer in China. Although the company has achieved strong earnings growth, we were concerned about its corporate governance. The company is indirectly owned by the local government and there have been several high-profile cases that involved senior managers being removed from their posts by the local watchdog. We believe a lack of transparency in distributor selection is an issue for the company.

Performance: Consistent risk-adjusted outperformance

The Invesco China Focus Equity Fund has outperformed its benchmark across 3- and 5-year periods (table 1). Even recently amid the heightened market volatility during the outbreak of Covid-19, the performance was resilient.

Risk-adjusted returns are strong
Importantly, the fund has also achieved substantial risk-adjusted performance with superior Sharpe, Sortino and Information ratios over a 5-year period, and, at the same time, the returns have demonstrated lower volatility (measured by standard deviation).

We believe the consistency of performance is one of the most valuable features of our fund. It has managed to outperform the benchmark index in the majority of cases on a monthly measured three-year rolling basis since inception. In addition, the fund's positioning has produced comparatively low drawdowns over a 5-year period, providing risk mitigation in weak market phases.

Outperformed by capitalising on consumer demand, the digital trend and innovative private enterprises
Over the last three years to July 2020, both sector allocation and stock selection added value. The healthcare sector was one of the largest contributors to performance due to the increasing demand for healthcare products and their perceived "safe haven" status during times of geopolitical tensions. In particular, a leading healthcare company delivered strong returns on the back of its rich product pipeline and solid R&D capabilities.

Elsewhere, two leading internet companies were positive contributors. An e-commerce platform outperformed thanks to its ability to increase retail penetration of its product categories; while a major games company's share price benefited from strong quarterly earnings driven by the launch of successful games. Finally, other innovative private enterprises such as a holding in a large hypermarket also added to relative returns as its share price was driven higher due to online and offline integration.

Table 1
Performance (net performance figures, USD, %)

	YTD	1 year	3 years	5 years
Fund	10.8	14.9	36.5	60.7
MSCI China 10/40 index	4.9	14.2	23.3	39.1
Sector	9.0	16.3	26.8	37.0

Standardised 12-month performance figures (%)

	31/07/15 31/07/16	31/07/16 31/07/17	31/07/17 31/07/18	31/07/18 31/07/19	31/07/19 31/07/20
Fund	-2.0	20.1	14.7	3.6	14.9
MSCI China 10/40 Index	-12.9	29.6	8.4	-0.4	14.2
Out/Underperformance	10.9	-9.5	6.3	4.0	0.7
Sector	-11.5	22.1	8.2	0.7	16.3

Past performance is not guide to future returns. Source: Invesco as of 31 July 2020 and Morningstar. Net figures are net of ongoing charges and portfolio transaction costs and do not reflect the entry charge payable by individual investors. All performance data is in the currency of the share class (Class E (accumulation - EUR). There is currently a discretionary cap of operating expenses at a maximum of 0.05% in place. This figure forms part of the ongoing charge and may positively impact the performance of the Share Class. As the Fund is actively managed, it is not intended that the performance of the Share Class will track the performance of MSCI China 10/40 Index (Net Total Return) (the "Benchmark"). Sector/Peer Group refers to Offshore and International Funds under China Equity categorized by Morningstar. *Fund incepted on 15 December 2011. Mike Shiao has managed the fund since inception.

Conclusion

In conclusion, we are positive towards the domestic economy in China and we like the rising digital trend that is being accelerated by the recent outbreak of Covid-19. We favour private enterprises thanks to their agility and sound corporate governance.
We are positioning the Invesco China Focus Equity Fund to capitalise on our views.

We believe it is important for investors to adopt an all share approach to capture the best opportunities in China. We define this as searching for the best investment ideas across all China's share classes irrespective of listing locations. We believe offshore equity markets provide a large selection of opportunities with growth potential, particularly among the consumer, services and technology companies. These are mostly private industry leaders, which were listed offshore as a result of their entrepreneurship and financial strengths. In addition, we see increasing opportunities within the onshore market, particularly among the consumer and healthcare companies, as it continues to mature.

Notes
1 Phrase 1 trade US-China agreement delayed indefinitely new tariffs on $160bn of Chinese imports and reduced tariffs on $120bn of Chinese imports to 7.5% from 15%.
2 Source: Citi Investment Research as of October 2019.
3 Source: Haitong Securities as of May 2020.

Investment Risks

The value of investments and any income will fluctuate (this may partly be the result of exchange-rate fluctuations) and investors may not get back the full amount invested. As a large portion of the fund is invested in less developed countries, you should be prepared to accept significantly large fluctuations in the value of the fund. As this fund is invested in a particular country, you should be prepared to accept greater fluctuations in the value of the fund than for a fund with a broader investment mandate. The fund may invest in certain securities listed in China which can involve significant regulatory constraints that may affect the liquidity and/or the investment performance of the fund. The fund invests in a limited number of holdings and is less diversified. This may result in large fluctuations in the value of the fund.

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Data as at 31 May 2020, unless otherwise stated.

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