Zentrum Sees Opportunities in China Demand for Luxury Goods: Q&A

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By Bei Hu

(Bloomberg) -- Increasingly wealthy Chinese consumers are driving opportunities in the nation's technology, automotive, pharmaceutical and liquor sectors as demand for luxury goods grows, according to Zentrum Capital Advisors. The Hong Kong-based firm's Zentrum Asia Opportunity Fund,

which largely focuses on China and Hong Kong equities, rose about 32 percent last year, thanks to bets in those sectors, said Chief Investment Officer Kevin Yuen. Yuen was interviewed last month. His comments were edited and condensed.

Can you give some background on the fund?

Zentrum uses a fundamental approach supported by technical analysis for stock selection, and quantitative techniques to manage trades and exposure. The majority of our portfolio (around 60-70 percent of our equity exposure) is normally long China and Hong Kong equities. However, if those markets are trending downward, we can increase exposure to other Asian markets that we are very familiar with, say Japan or Australia.

We have even taken positions in the U.S. and European stock markets on firms that are strongly influenced by Chinese demand. In 2015, when the Chinese government started its anti-corruption drive, we took successful short positions on luxury goods stocks such as LVMH, Hermes and Swatch. If equity markets are challenging, we can move into corporate debt. We like Chinese companies that have a state-owned enterprise background, where their debt can yield 5-6 percent. And finally we can get into cash if we need to; our net exposure has been as low as 10 percent.

The fund has an annualized return of 12.2 percent since inception in 2010 to January 2018 with 8.7 percent annualized volatility. It was up 2.4 percent in January, and rose about 32 percent in 2017. On a net basis, it was up seven out of the last eight years that it has been trading. In 2016, it was down 0.99 percent.

How do you select and trade stocks?

We divide our stock investments into two buckets: equity fundamental and tactical trading. In equity fundamental we look to hold stocks in companies with strong track records and leadership, for upward of two to three years. For example, we've held our position in AIA for nearly three years.

In tactical trading, we tend to rely more on technical analysis of growth stocks, such as Alibaba and Tencent, which we trade.

What is the most attractive opportunity you are seeing now?

One Chinese company that may have the best global growth potential is Alibaba. Its business model fits consumer needs, providing ease of access to a wide range of goods, and is a service that we think will become indispensable to global audiences. Its simplicity, combined with service quality and an existing exposure to Western markets, makes us confident that Alibaba can profit globally. It appears we aren't the only people who hold this view -- the first Chinese representative that President Donald Trump met after his election was the company's founder Jack Ma, a clear indicator of the future potential of Alibaba.

What's your outlook on this year's investment environment?

We're cautiously optimistic. Short-term market corrections are likely, but we see a consistent uptrend. We continue to be bullish on the Chinese market as there are a plethora of companies with high growth potential. Moreover, we view the political/economic situation in China to be stable, and expect the economy to achieve steady growth.

What drove last year's 32% return?

The sectors we liked in China last year -- and still like this year -- were auto, tech, pharmaceutical and liquor. These sectors all demonstrated that they were following broader Chinese macro trends, whereby consumers are becoming increasingly affluent and thereby demanding more luxury goods. In the automotive sector, demand for premium marques has seen consistent growth, and Brilliance China Automotive stock reflects this trend. Brilliance's ties with BMW mean it is associated with a top global brand, coupled with strong and stable corporate governance, which we believe will fuel growth.

The liquor sector is also influenced by Chinese consumers looking to upgrade their lifestyles and aspiring to consume premium brands. Our investment focus has been on domestic brands, such as Shanghai-listed Moutai, which has high gross margins.

The pharmaceutical sector is of interest as the ageing population and increase in private health care provide growth potential. Chinese pharma companies are focusing on developing their own patented products, which we view as good for stable future growth. As a result, Chinese pharma firms are working on some of the most innovative products in the sector. We believe Jiangsu Hengrui Medicine and CSPC Pharmaceutical -- stocks we are holding -- are among the most innovative, investing heavily in R&D with a proven track record of delivering products.

What else?

The tech sector, particularly internet stocks and smartphone producers, are also areas of interest. Internet firms like Tencent and Alibaba are extremely powerful in the Chinese market and also highly innovative. Chinese smartphone producers are profiting from the global increase in smartphone consumption. Our holding in AAC Technologies provides consistent share price growth, while its move into developing smartphone lenses expands an already innovative product pipeline.

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