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CHINA: HOW OUR INVESTMENT APPROACH TRAVELS

VIDEO #1: THE CURRENT LANDSCAPE AND OPPORTUNITY

Rachel Davies (RD): As many of you will know, Burgundy's investment approach focuses on analyzing businesses and not predicting macroeconomic trends. However, in any conversation on China, I think it's important to recognize or acknowledge the unprecedented economic growth and prosperity over the past two decades. Just for context, over the past two decades, the U.S. economy has doubled, while China's economy has grown twelvefold. Ching, what are your observations from studying China over this period, and where is the country today?

Ching Chang (CC): Rachel, if you look at the tremendous growth China's experienced over the last 40 years, today it is the second-largest economy in the world and it has the second-largest stock market. During that time, 800 million people have been lifted out of poverty. Personal incomes have risen more than 165 times and are still growing

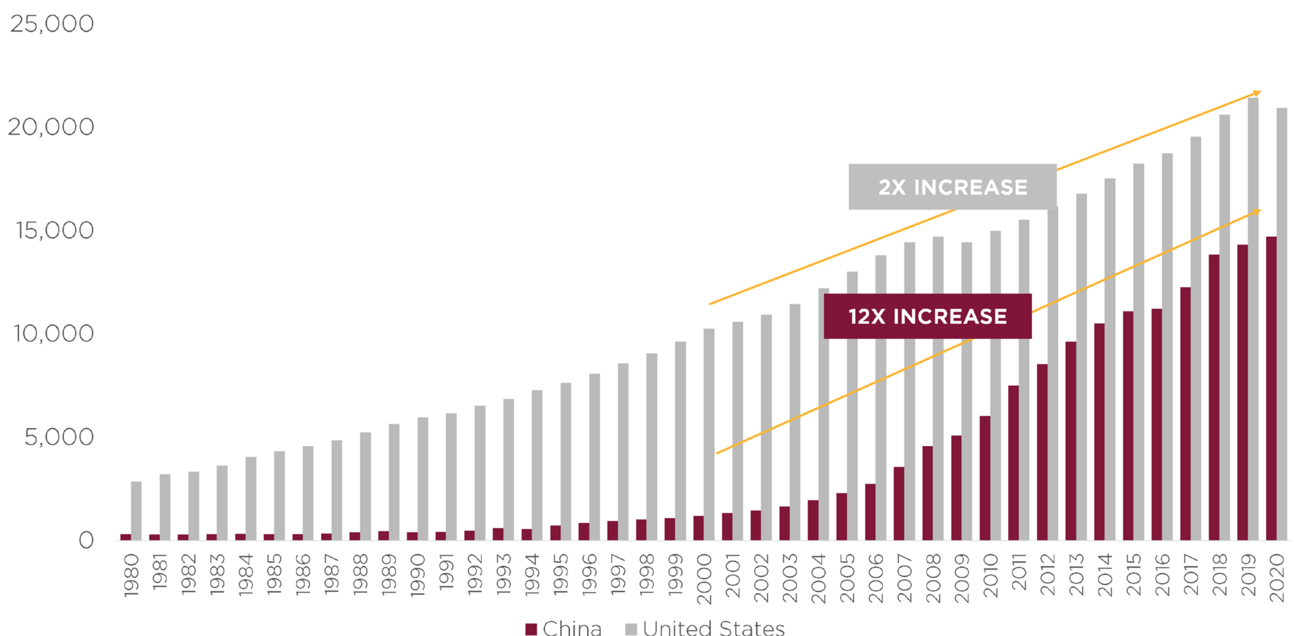
5-10% per year. Millions have entered the middle class. It's an unparalleled achievement in human history. The education system is better than almost anywhere else we see in the emerging markets and compares quite favourably to most developed markets. And if you looked at the Live Change Index, someone who was born in 1990 would have seen GDP per capita rise 32 times in China during that period, compared to 2.7 times in the U.S.

What that means, if we look at it from the lives of people, is that back in 1990, China's rural population would have had one refrigerator per hundred household, compared to 96 today. There would have been only five and a half million cars on the roads in total in all of China, compared to 270 million today. And more than 75% of the population was rural, compared to two-thirds today being urban. So it's been unprecedented in terms of the changes that people have undergone. On the business side, we've seen the rise of private businesses that thrived in a more market-driven economy. And this has given rise to many fantastic entrepreneurs and globally competitive businesses.

RD: Thanks for the context. I think it's hard for any of us to imagine what that amount of change feels like. And there's a lot of debate about where China goes from here after a period like that. So can you tell us what you foresee from China over the next decade?

CC: If you look at the tremendous growth that China has undergone, many believe that it can't continue. However, what we observe is that China's not uniform, right? The narrative of one China is a false one. So for foreigners that go to China, they mostly stick to the tier-one cities, the large cities like Shanghai and Beijing. And those are very developed. And they compare in terms of development on the same scale as other world-class cities around the world. However, if you look below that in the lower-tier cities, income per capita is still much lower. And overall in China, GDP per capita is only US$10,000 per person.

So as we look forward to the next 10 years, what we see is a repeat of the pattern, where these lower-tier cities will also see rises in income in terms of wealth of these people, and these people will look to consume more as their income rises. At the same time, even below those lower-tier cities, we still see another 400 million people living in rural areas that will urbanize over the next decade. So, as we look at China going forward, we see tremendous opportunity for



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continued growth from the rise of these lower-tier and rural areas. And some estimate that over 500 million people will enter the middle class in China over the next decade.

RD: Whenever we talk about China, I'm always amazed by both the pace of change and just the scale of it all. So you said 500 million people, that's one and a half times the size of the U.S., moving into the middle class. It's a pretty astounding number. Can you tell us based on these trends where you're seeing opportunities in China?

CC: The obvious one is with consumption, both consumer staples and consumer discretionary. China's large population is going to look to consume more. And not only that, but consume more and better products, more premium products. And this is an area that we believe will be a very profitable one in finding new investment ideas. The other sector that we are excited about is within technology. And if you look at kind of the intersection of consumption and technology, you see the rise of e-commerce, and China has the largest e-commerce market in the world right now. And if you look at just Alibaba, the largest e-commerce company within China, over one trillion U.S. dollars of goods are sold on its platform every year.

RD: How does that compare to Amazon?

CC: It's almost twice as big as Amazon.

So another area that we see an opportunity for investment ideas is in domestic substitution. So we believe China will want to build up its own technology ecosystem over time. And that's going to mean that you're going to see Chinese companies rise in areas such as industrials and healthcare based on their own technology. Oftentimes, these companies will position their products as value for money. So even though the quality most times won't be nearly as good as their multinational peers, they're able to sell these products at a substantial discount. And we believe, over time, they're going to reinvest these profits into R&D [Research and Development] to improve the quality and technology of their products and close that gap versus their peers.

Finally, what we look for are just fantastic entrepreneurs that are able to take advantage of all of these opportunity and growth tailwinds. Unlike other markets, where you tend to find entrepreneurs in more technology sectors, in China, we see it across a whole spectrum of different industries from restaurants, bottled water, infant formula, as well as technology.

For us, I think the focus on management teams is because when you have a tremendous growth opportunity, like we see in China, and where the pace of change is faster, the role of management is that much more magnified. Each decision made is that much more important. Take, for example, a company that's growing 20% a year, it takes under four years for that company to double in size. And so each decision made in that interim period is that much more important. Compare that to a company that is only growing 4% a year and where it takes almost 20 years for the company to double, often outside the tenure of most management teams.

RD: Right. Yeah, the stakes seem a lot higher for management than what we see elsewhere. Can you provide an example of a team in China that's done really well during this period?

CC: I think one example is with our portfolio company, NetEase. NetEase is the second-largest gaming company in the world and also in China. NetEase was founded by William Ding in 1997, originally as an internet portal and email service. At that time, there was only 600,000 internet users in all of China, but by 2003, there was going to be over 80 million. So there was tremendous opportunity for growth there. However, for NetEase, during the tech crash that we saw in the early 2000s, they ran into financial trouble because a large part of their revenue base came from online advertising revenue. And so at that time, William had to make a decision to pivot the company towards gaming. And they've been able to release some tremendous hits that really resonated with the Chinese consumer and that are still in operation today. At the same time, NetEase today continues to reinvest in the business, looking in other areas, such as online education as well as online music. All of this is based on the vision of William and his ability to capitalize on these opportunities.

RD: Hearing you describe NetEase's business transition makes me wonder about the role of moats in China, which we talk about a lot at Burgundy. For those that aren't familiar, a moat helps to protect a business from competition and helps it sustain its profitability. So, Ching, if markets are evolving so quickly in China, how can companies protect their moat?

CC: Yeah, I think given that the market structure is different in China, the analysis of a company's moat also has to be different. In developed markets, we look for companies that are established and have stable moats. Companies that can defend themselves against the emergence of new competitors over time. In China, though, we look for companies that are able to grow and expand their moats over time. This is because the growth rates in China are so much higher, the market is much more fragmented, and moats are less established than they are compared to more developed or mature markets. And, therefore, a competitive advantage has to be strengthened over time. It's not strong enough today for them to stand on their own. And what we look for are companies that are able to do that, companies that are getting stronger over time, that are getting their fair share of growth, and that are able to, over time, widen that moat.

VIDEO #2: LESSONS LEARNED FROM BURGUNDY'S EXTENDED RESEARCH TRIP

Rachel Davies (RD): Ching, some of our clients will recall that you went on an extended research trip to China in 2018 and 2019. A lot has happened in the world since then. Can you remind us what you did on that trip?

Ching Chang (CC): Sure, Rachel. Yeah, so as you mentioned, we went on a six month extended research trip where we worked and lived in China and really ingrained ourselves in the fabric of society. We stayed in three main locations in Hong Kong, during which we visited the province of Guangdong in cities like Shenzhen, Guangzhou and Foshan. Guangdong is a major technology manufacturing hub. And, so we were able to meet some of the companies that are based there.

We then spent time in Beijing, which is the political heart of China, but also home to many of its internet companies given the presence of the two leading universities in China. While we were in Beijing, we also visited the surrounding areas in Northeast China, in cities such as Qingdao, Shenyang, and Tianjin.

Then we spend time in Shanghai, which is the commercial heart of China, where many businesses are based. We visited around the Yangtze River Delta and cities such as Hangzhou, which is another technology hub, and Ningbo and others. So in total, we had over 200 meetings, not only with companies, but also with what we call context meetings. So, people such as reporters, government officials, academics, industry experts, and other investors.

RD: So, prior to this extended visit, Burgundy had been studying the Chinese market for over two decades. What were some of the key findings from this trip that you didn't appreciate before?

CC: I think one of the key observations was really the pace of change. And this was something we observed before from our previous research trips but seeing it up close and personal and for an extended period of time, it really leaves a very strong impression. And we joke that each year in China is like a dog year. It's kind of three years elsewhere. And the speed of change we observed, really you see it in an adoption of new technologies, such as e-commerce such as mobile payments. At the same time, we have also seen that the speed of change is something that Chinese companies have been able to use to their advantage.

If you go back 10 to 15 years ago, there was a belief that multinational companies would be able to dominate many

94% of China's population lives east of the dotted line.

industries in China and out-compete their domestic Chinese peers. What we have seen since then in that time period is actually the exact opposite. That many times it's the Chinese peers that have been taking market share and winning markets away from the multinational competitors. And this is because these Chinese companies are able to move at a much faster pace. They're often decentralized in fashion. They're able to iterate very quickly and move faster with consumer trends. You compare this to a multinational company, which often have to report back or seek approval from their headquarters back in the U.S. or back in Europe. At the same time, they have a brand that is global. And so it needs to be uniform and needs to be protected in terms of brand image and so can't cater as much to the local market.

And I think I also have to mention the work culture that we see here in that we often hear about 996 work culture, which is 9:00 a.m. to 9:00 p.m., six days a week and we see this in many places. So, you combine this work ethic with sort of the entrepreneurial spirit and the speed of change, and what you get is kind of the Chinese domestic companies have been really able to out-compete their peers.

RD: So, when I think of China, its hardworking labour force and large labour force often come to my mind. Are these the key factors that have enabled this fast pace of change?

CC: I think that's a part of it, but I think there are a few other factors that have enabled this speed of change. First is the lack of legacy in the ways of doing things, which has allowed China to leap frog certain technologies. For example, most people's first experience in accessing the internet is via their smartphones, not via a laptop or a PC computer. On the mobile payment side, many people never had credit cards and their first form of digital payment was via their smartphone and via a mobile wallet.

I think the lack of legacy means people are often switching from nothing, which makes it easier to adopt new technologies versus disrupting existing ways of doing things. The other factor that's enabled this speed of change is the infrastructure that has been built out. China has some of the best infrastructure in the world, not only in terms of physical infrastructure, such as roads, ports, and high-speed rail, but also in terms of what we call infrastructure for the 21st century. Things like mobile networks and digital payments. And enabling this infrastructure to provide cheap and readily available data or payment has really made pace of change faster.

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RD: So, some might say that China has been able to do this because they've copied technology from developed markets. What's your take on that?

CC: If you look at the past development of China over the last 40 years, I would say that's certainly true. China has essentially undergone 150 years of industrial revolution in 40, and most of that is done through brute force imitation of existing practices and technology from the rest of the world. However, there's an increasing recognition within China that to continue to grow and develop, they're going to need to innovate more, and they are innovating.

Part of this is driven by the fact that the aging demographic in China means it no longer can rely on this cheap and vast population, but rather needs to improve the productivity of this population. In some ways, China is already a leader in innovating on new business models. So, we see this in areas such as e-commerce. And what this has been enabled by is really what we call the STEM dividend. So, in China every year, there are five million science, technology, engineering, and math graduates (STEM). That's more than the U.S., Japan, Germany, France, Italy, UK, and Canada combined.

At the same time, many overseas Chinese are returning back to China, either due to the fact that they're hitting a glass ceiling in their existing roles in the West or because they see more opportunities in China. As I mentioned, some of the areas in which China is leading is in areas like e-commerce, and

we're starting to see the emergence of new business models, such as livestream e-commerce, social e-commerce and customer-to-manufacturer business models. At the same time, China is a leader in electric vehicles with nearly half of all electric vehicles sold in the world being sold in China.

And they've also developed a tremendous supply chain related to electric vehicles and given rise to the biggest battery manufacturer in the world. So, I think going forward, you're going to see companies increasingly study China in looking for models that they can export to the rest of the world.

RD: That's interesting. A STEM dividend is a new concept for me. So, you've been to China on research trips many times before, but this extended trip seems to have been pretty helpful to your thinking. How are you going to approach travel going forward?

CC: I think when we look at China, we realize that we need to spend a significant amount of time in China, on the ground doing firsthand research. So, going forward, we plan on spending three to four months a year in China conducting some of that firsthand research. But, at the same time, we realize that it's also important to spend time outside of China. China is a very noisy and highly volatile market. There are rumors constantly flying around. So, it was key for us to spend time away from that in order to dispassionately evaluate the investment opportunities and distill our learnings and not get caught up in the narrative of the day.

This is especially important in the periods of high momentum, either up or down, where the sentiment can affect your thinking. So, we believe spending time away from China would enable us to do this and allow us to make better investment decisions.

VIDEO #3: BURGUNDY'S EDGE

Rachel Davies (RD): China's a large market, and it's far from Canada. So it's natural to question how a small team sitting in North America can have an advantage. What do you see as your advantage in China, Ching?

Ching Chang (CC): When we look at China, one of the things we like about the market structure is that 80% of its trading is done by retail investors. And often, they don't have the tools and knowledge necessary to assess businesses. At the same time, because of this retail behavior, the institutional investor base in China has similar constraints. The underlying mentality of the owners means funds have to think in very short-term increments and that often you get evaluated on a monthly or even weekly basis.

One example is a survey recently, which showed that 50% of mutual fund investors in China would hold on to their mutual fund units for less than three months. Whereas in the U.S., only 10% of investors would hold their fund units for less than three months. This means that fund investors have to be more short term and more momentum-driven.

And what this allows us is that for us to take a longer-term approach, we're able to look beyond some of the short-term volatility. And this is enabled by our clients, like yourselves, who also think longer term. This means we're able to maintain our valuation discipline in periods where things are very expensive and not chase the momentum up. At the same time, we're able to act opportunistically when sentiment swings the other way, and we see stocks on sale during those periods of volatility.

And I think the other advantage that we believe we have is that both David and myself have had experience covering more developed market companies and more mature companies.

RD: Ching, can you elaborate on that last point? In our second video, you mentioned that China is moving at a faster pace than anywhere else in the world and that Chinese businesses are now leading in many areas. How does having experience in developed markets help you?

CC: I think the extensive experience we have in developed markets allows us to form frameworks based on the things we've observed and draw parallels on what businesses will look like as they mature in China and really map out that development path. Even though in certain areas China is leading and we're seeing the emergence of new business models, in others, China's still undergoing that process of development and consolidation that we've seen already happen in other countries. That means the knowledge of what these businesses can look like in their mature state allows us to chart a clear path of whether China will follow a similar path, what are the differences, and what are the characteristics of the winners of those industries?

Another point on this is that because of Burgundy's global reach in our investment efforts, it means that we can learn from our colleagues covering the U.S. or Europe about what they're seeing from their companies who also have operations in China. A way in which we're putting this in practice is if you look through our portfolio today, even though the names might not be familiar to you, the business models would be. You know, companies such as Zhongsheng or MeiDong are auto dealers similar to a Penske that you see in the U.S.

You know, a company like ZTO, which is an express parcel delivery company, is similar to a UPS and a company like Alibaba, which is a e-commerce company, would be similar to Amazon. So you see the business models are quite similar, and having knowledge on what these business models can look like at maturity help us chart that path forward.

RD: You described the investment landscape as noisy and sort of short-term oriented today, and that gives rise to opportunities to buy good businesses at a good price. But we know that a large market that's growing and has high-quality businesses is going to attract more attention over time and that volatility and those opportunities may diminish. So what are you going to do to try and maintain an edge?

CC: We realize that Chinese investors are increasingly learning from the development of more mature markets. So we do not believe that our information or analytical advantage will be sustainable over the long term. Another reason is regulation, and the internet is just making information that much more accessible and the ability to learn about investing

CHINESE EXAMPLE

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concepts that much easier. Similarly, the professional investor base will also grow in size and sophistication.

Therefore, what we strive to do is we try to maintain our informational and analytical advantage for as long as we can through the development of proprietary industry expert networks for a network of kind of other investors that we can speak to, both on the private and public side. At the same time, we'll strive to build new competitive advantages, such as building our reputation as thoughtful long-term investors, so that management teams want us as shareholders.

And, ultimately, we realize the only sustainable long-term advantage is a behavioural one and perhaps a structural one offered to us by our investors such as yourselves that really allow us to stand apart from the crowd and make contrarian calls when we believe that the risk-reward is very attractive. This behaviour edge is really the ability to maintain focus on the long term and not get caught up in the short-term noise of monthly or even quarterly results and short-term gyrations.

At the same time, we want to understand the longer-term goals of management and really the culture of a firm and whether they have the ability to capitalize on the longer-term growth opportunities. We believe those are going to be advantages that can be sustainable over the long term.

RD: I want to come back to the point you said about building our reputation with management teams so that they want us as shareholders. Can you elaborate on how that's helpful?

CC: I think it's helpful on several fronts. First is it allows us better access to management teams, higher-level executive as well as kind of the middle executives that are doing the everyday execution. At the same time, when we build that trust with management teams, they are more open to suggestions from us on how they can improve things like corporate governance or investor communication.

VIDEO #4: NAVIGATING THE RISKS

Rachel Davies (RD): Ching, in previous videos, we spent time talking about the opportunity in China, and now I'd like to focus more on the risks. One of the top barriers that we hear from clients and potential investors is that they have a lack of trust in the Chinese government. How do you approach this?

Ching Chang (CC): So we're aware of the risks that government plays in investing in China. They obviously have a much bigger role in terms of the overall economy and setting regulations and as industry participants versus what you might see elsewhere. So one way we're mitigating that risk is really staying away from those highly regulated industries that often face more regulatory scrutiny. We prefer sticking closer to the consumer where it's harder for government to regulate and where it's harder for government to influence say what kind of shampoo or what kind of air conditioner people should buy. We also look for companies that are taking a total stakeholder approach, that those companies are able to treat employees, consumers, and shareholders well and really align with the longer-term priorities of the government. We emphasize that this approach is taken by us in almost all regions that Burgundy invests.

RD: So you talk about our preference to avoid highly regulated businesses and staying closer to the consumer, and, yes, that's what we like to do in all the regions where we invest. But in recent months, we've seen several Chinese consumer and technology companies come under pretty high regulatory scrutiny. So how do you reconcile your strategy with what's happening?

CC: So we often read in the West that Chinese regulation seems to come out of nowhere. It seems to be capricious in nature and it operates more like a black box. But based on our observations, usually when the government introduces regulation, this has been something that's been in discussion for many months, if not years, right? They often take feedback from the industry. So there are a few takeaways from this. First is that regulators do not target companies. They target poor practices within an industry, similar to what you might see elsewhere. Then often, these discussions that are happening with industry participants are happening behind closed doors and usually not picked up by Western media. So when it does come out, it comes out as a surprise. But I think for us, it's key to understanding what these discussions are and what is being talked about.

RD: How do you get a sense, though, of what's being discussed behind closed doors and get a sense of what's coming?

CC: One is by discussing these issues with our network of contacts. We often get a feel for the direction of regulation this way. I will emphasize that it's often companies that take a total stakeholder approach and are benefitting all stakeholders. Regulation oftentimes is more beneficial than detrimental as it eliminates uneven competition where some of your competitors might be using more unscrupulous practices where you can't compete with them because of that. I think Chinese regulators overall are pretty keenly aware of the need to align the desires of broader society with how they regulate in their overall goals in order to maintain legitimacy of its ruling power.

Historically, what we've seen is that Chinese regulation tends to be a pendulum that swings from more laissez-faire to more tighter regulation. During the early periods of a development of industry, governments will often be more laissez-faire. They'll often allow the development of these industries unimpeded in order to promote economic growth as well as innovation. However, over time, there's an eventual shift that happens as they feel a need to safeguard the stability and fairness of society. This happens because during those early periods of looser regulation, you often see a buildup of poor practices within an industry. So clearly today, what we're seeing is that shift. We're seeing a shift towards tighter regulation, but I think it's a natural development. And what we've seen also is that it's come with pretty broad support from the wider population in China.

RD: So, Ching, I want to take what you said and sort of put it into context. How do some of these ideas apply to what's going on with Didi for example?

CC: Yeah. So Didi is a ride-sharing company similar to Uber. It's a stock we do not own, but one that we've been following for many years. So, initially, regulators were very supportive

> Historically, what we've seen is that Chinese regulation tends to be a pendulum that swings from more laissez-faire to more tighter regulation.

of Didi going public, but wanted to finish the review of Didi's cybersecurity and data protection procedures. Didi has very highly sensitive data of where people are going, and the government felt that it was crucial to protect this. So Didi was asked by the regulator to delay their IPO until this review process could be completed. Didi ignored regulators and went public anyways. That is what you're seeing play out in the news today. I think, at the same time, other shareholders of Didi, such as Alibaba and Tencent, also told them to delay. So I think what we're seeing here is that Didi really hurt themselves by ignoring both what their shareholders as well as regulators asked them to do.

RD: Let's move onto legal protection because that's another concern that we hear frequently from clients. How do you get comfortable with there being fewer legal protections in China?

CC: I think about this a little bit differently. We think about it from a more first principle basis where we think that if you need legal protections, if you need to enforce your legal rights, oftentimes you already lost a lot of money. I don't think legal protection has really protected Enron, or Lehman, or WorldCom shareholders. So what we try to do instead is look for long-term partners. We try to look for people who are going to act with integrity and treat us fairly, someone who has proven that philosophy of partnership. So then that means avoiding companies that we do not trust the management team or the controlling shareholder, even if legal protections were very strong.

RD: It's a fair point about Enron and WorldCom. So what about financial risks? How do you get comfortable that the information that is reported is accurate and that you can use it to make the projections you need to do?

CC: I think for us, we don't take the reported financials at face value. We conduct our due diligence to ensure that what is reported is accurate. I'll provide you some examples. When we look through the income statement of a company, right, such as revenues, such as cost of goods sold and operating costs, we try to verify each of those items. So, for example, take Tingyi, a portfolio company that we have that provides instant noodles as well as non-alcoholic beverages, such as ready to drink tea, water, and carbonated soft drinks. We would verify that the revenues they reported are accurate by looking at third-party studies in terms of market share, market size. We'd also talk with retailers and distributors to ensure that this is the price they're selling at, and work out that the size and scope of the sales are accurate.

At the same time, in order to verify the cost that the companies have, we would speak with competitors and former employees to verify that the cost of making, say, a bottle of a carbonated soft drink in terms of the PET costs, the sugar, the water, the syrup are all accurate in terms of what they report. We would also look to the cost structure and ensure that the amount, based on the total employees that a company has, being paid to each employee is representative of what the average wages would be within that region. And we would dig in further if there were major discrepancies. I think, ultimately, we would put all of this information together and verify whether the financials reported by the company are accurate or not. Finally, we look for companies that pay excess earnings in the form of dividends or buybacks, because ultimately it's very hard to fake the cash.

VIDEO #5: ANALYZING ESG FACTORS IN CHINA

Rachel Davies (RD): In 2019, Burgundy signed the United Nations Principles for Responsible Investment, joining a network of institutional investors that are working to incorporate environmental, social, and governance considerations into investment decision-making, also referred to as ESG. Ching, how do you incorporate ESG analysis into your research and analysis of Chinese investment?

> “The Chinese concept of 德 can be thought of as virtue or morality where a person (or company) positively influences society.”

Ching Chang (CC): I think the overall principle of what we look for in China in our companies is the Chinese concept of virtue, which you can think of as a person or company that positively influences society. It's very similar to the idea of stakeholder capitalism, where management teams are not only focused on shareholders, but overall impact on society, such as its employees, its consumers, and broader society.

RD: So, Ching, let's review your approach to each of the factors then. Let's start with environmental.

CC: I think for environmental, this is becoming a much bigger emphasis in China because it's becoming more important to consumers who are increasingly aware of green consumption and their environmental impact. And they have a greater willingness to pay for premium products that are more environmentally friendly. At the same time, there's a greater government push for more environmental protection, such as carbon neutrality, a goal where China seeks to be carbon neutral by 2060.

And, I believe that they're going to hit this goal. When China sets these targets, they usually try to move mountains to kind of meet these goals that they have. And, so what we look for are companies that are not only meeting the minimum legal requirement, but are actually leaders in the industry in terms of environmental standards. And, they often help to set standards in the overall industry for other players to copy. And, why this is important is that with greater emphasis, we believe that these environmental protections will only get tighter over time. And so if you meet only the legal minimum today, your business is going to be impacted in the future.

RD: How about social considerations?

CC: For social, I think it's very important point to point out that Asian culture has a much greater emphasis on society rather than the individual as a prime mover within their culture. And, therefore, we have to look for companies that take a stakeholder approach. Now, that's extremely important in ensuring that the business practices are sustainable to ensure that they're benefitting everyone that they touch. Employees, consumers, shareholders, and broader society. And, not those companies who are making short-term, unsustainable profits by ripping off consumers or squeezing employees. Also, we believe that those types of companies would be much more likely to face regulatory scrutiny.

RD: And finally, governance.

CC: I think on the governance point, I like to separate it into two that people usually raise. One is kind of the governance at the system level and relating to the regulatory and the governing party within China. And, the second is governance at the company level. In terms of the system level, the view of the Chinese regulatory processes as a black box we have talked about this in previous videos about how we deal with that risk and how taking a total stakeholder approach helps us to mitigate some of that. At the company level, the basis of good governance is trust and building that trust between shareholder and the management team, and looking for long-term partners that have a track record and philosophy of treating minority shareholders well.

It's important to keep in mind that good governance continues to evolve in China. Publicly traded companies are still a fairly new concept. The Shanghai Stock Exchange only opened in 1990. Therefore, what we look for are management teams that are looking to do the right thing, but who might not be quite there in terms of execution or knowledge. We believe that we have the ability to become good partners with these management teams and help them improve their corporate governance standards over time.

RD: In our last video, Ching, we spoke about how you analyze risk in China. Is it fair to say that you see ESG analysis as a key part of your risk-mitigation framework?

CC: Overall, we believe that ESG is very important incorporating into our investment analysis. As mentioned, it's becoming an increasing focus for consumers, companies, as well as regulators. We believe that companies that score well on ESG will be more aligned with the broader goals of the government and therefore face less regulatory scrutiny.

VIDEO #6: THE BURGUNDY CHINA FUND

Rachel Davies (RD): At Burgundy, we follow one investment approach that we refer to as our quality value philosophy; however, there are nuances to applying this approach in various markets. Ching, how do you apply Burgundy's investment philosophy in China?

Ching Chang (CC): I think from a portfolio construction standpoint, we look to be very concentrated and very differentiated. And what I mean by that is to look very different from our underlying benchmark. We want to be concentrated because we believe in putting money in our best ideas, rather than diluting the quality of our portfolio with more marginal ideas. In terms of sectors, we are going to be a lot more focused on the consumption opportunity as well as the fact that more high-quality companies can be found in these sectors. Given that focus, you could see in the portfolio today, over 55% of the portfolio is invested in both consumer discretionary and consumer staples companies. We continue to believe that there's going to be a big opportunity within consumption over time because of rising incomes as well as consumption upgrading. At the same time, we will also be focused on other sectors we believe that have a greater prevalence of high-quality companies, in sectors such as technology, industrials, and healthcare versus sectors like energy, metals and mining, and financials where it's much harder to find high-quality companies.

RD: You know, this sounds pretty consistent with a number of regions where we invest and particularly outside of Canada where the stock markets are more diversified in terms of different sectors. Is that right?

CC: Yes. That's right, Rachel. I like to add, though, another focus for us is looking for companies more in the mid-cap range where we believe the runway for growth is much greater and where companies can be less known and therefore have greater opportunities for finding underpriced securities. When we think about the market, we divide it into two buckets. The first is what we call persistent high-quality companies. These are kind of your classic high-quality compounders that tend to be better known, more fairly valued, and already on the larger end of the market-cap spectrum.

CC: But we also want to spend time in companies that we call emerging companies or emerging-quality companies. These are what we believe to be the next highly successful and high-quality companies in the market. And these can emerge in several different areas. You know, it could be due to the fact that these companies are still early in their life stages. It could be the fact that these companies are already market leaders in an industry that is facing significant secular growth. It could be companies where we see high fragmentation and they're consolidating the industry and therefore building those scale advantages, or they could be companies where we see a change in the industry structure or in the management team where the economics aren't going to improve over time. We think that spending time here is very important because this is where we can find all those outsized returns.

RD: This idea of emerging quality seems like more of a nuance to investing in China. Can you provide us with an example?

CC: One example of this is with the auto dealers that we're invested in, Zhongsheng and MeiDong. We have been fol-

lowing the auto dealers for a number of years. And at the time when we invested, what we noticed was that there was a shift in the industry that was happening, a shift away from more volatile new car sales towards more stable and recurring after-sales revenues. This shift means that these businesses were going to be better companies in the future. At the same time, we saw continued strong growth in the underlying luxury market, where both of our companies are focused, and we saw a highly fragmented market where there were opportunities for consolidation. These factors mean that our investment in Zhongsheng and MeiDong have been very successful investments for us.

RD: We've seen that China can be a very volatile market. How are you planning to manage this?

CC: The Chinese market is very volatile, and it's something you should expect along with the fact that because we run a fairly concentrated portfolio that looks very different from the benchmark, the underlying volatility won't only be in the portfolio but relative to the benchmark. So I would tell you to expect volatility in the market and plan for this. Investors need to take a long-term view. And these periods of volatility should be viewed as opportunities similar to how we view them in other markets.

CC: You should be prepared though that during these times the headlines will look extremely ugly. And we're starting to see some of that today. But we are prepared to add to our existing positions or even buy new companies that we've been watching for some time but the valuations were too expensive to buy. For us, when volatility hits the market, we go through a checklist to make sure that we're not making emotional decisions. We first try and look through our portfolio companies to ensure that nothing has fundamentally changed. We then look through our Dream Team list to see if there are any attractive risk-reward relative to what we own in the portfolio or areas where we can upgrade on quality. Then we look through the rest of the market to see if there are pockets that we have severe dislocation that also offer attractive opportunities.

RD: So should we expect a different pattern of returns compared to some of the other regions where we invest, Ching?

CC: I think you can expect a similar pattern of returns, but there are a few nuances of China. One is that the underlying volatility is much greater and that markets tend to be momentum-driven, so they tend to overshoot on the upside or the downside. We also see that market cycles tend to be shorter in China, so these periods of volatility tend to come more often. But key for us is that during these periods of volatility, we want to be aggressive in looking for those opportunities to upgrade the quality of our portfolio or look for more attractive risk-reward.

CC: Overall, if you look at the China strategy and how it's likely to perform in the future, when we see periods of euphoric markets we'll tend to underperform as we stick to our valuation discipline and not chase companies to astronomical valuations. However, we also tend to outperform on down cycles due to the more defensive nature of our holdings. And key for us is to really upgrade the quality of our portfolio during those periods when the markets are down significantly, and hopefully when the market recovers those are the companies that get recognized first. ■

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