

Nov. 22, 2007

## **A major change in my A share portfolio screening model**

Dear students and friends,

Starting from the last week of October, the current stock market correction already wrote off almost 1000 points for the benchmark Shanghai index. Nobody knows when this round of correction will end, but two things are for sure: 1. even after this severe correction, most of the A share companies are still dangerously overvalued (see the recent article in Business Week in which I was quoted: [http://www.businessweek.com/globalbiz/content/nov2007/gb20071115\\_882808.htm?chan=search](http://www.businessweek.com/globalbiz/content/nov2007/gb20071115_882808.htm?chan=search)); 2. this is surely not the end of Chinese bubble period. The previous Japanese and Taiwanese experiences tell us that the craziest time is still about to come.

In today's particular historical moment, everybody is questioning when the real turning point of Chinese capital market will come. My view on this is when the major of the players in this market realize that A share listed companies as a whole group can not grow as rapidly as they used to do (at least many investors have the perception that they have been growing rapidly during the recent period). As a person strongly believing in fundamental analysis, I think in order to better predict the future, we need first of all to study seriously the past and the present.

### **How did A share companies grow during the last years?**

So have the majority of A share companies been growing rapidly during the recent period? Before answering this question, we need to define what the growth is. There are many ways to define the growth. Some of them are very partial and biased, for example, net assets may be increased through the profit generation or through the capital increase or both, and a company may increase dramatically the sales without having any positive impact on the bottom line<sup>1</sup>. In my view, the growth should strengthen the firm by having a healthy size increase and a profitability improvement. Therefore, I choose the first indicator related to size growth ( $G_1$ ) and the second indicator related to profitability improvement ( $G_2$ ):

$$G_1 = \text{Gross margin}_t / \text{Gross margin}_{t-1}$$

$$G_2 = \text{Adjusted ROS}_t / \text{Adjusted ROS}_{t-1}$$

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<sup>1</sup> From 1999 to 2000, Enron's sales increased 151.27%, however the net income/sales dropped to less than 1%!

Here the “Adjusted ROS”= (Net income-investment gains-Income from assets fair value revaluation-Non operating income)/Sales.

And then I calculated the average  $G_1$  and  $G_2$  by taking the growth rates between 2005-2006 and 2006-2007 (the numbers for 2007 is annualized.). Since I believe the profitability improvement is more important than the size increase, I weighted 1/3 to  $G_1$  and 2/3 to  $G_2$  to get the combined unique growth indicator G-score.

We find only 613 A share listed companies have a positive G-score for the last three years (40% of total population)! These results are quite away from the general very positive perception most investors have on A share listed companies. Another interesting result is that again very different from the general perception, at least in China; the growth is NOT a function of business line.

### **My concerns on the future growth perspectives**

For recent months, more and more bad news on Chinese and international future macroeconomic conditions have been popping up constantly: Domestically, the sharp increase of CPI, the raise of interest rate, the raise of raw material prices and labor costs; internationally, the appreciation of RMB, the US economy weakened by subprime and real estate crisis. All these factors are pointing to the real inflation in China and to the increasing difficulties for Chinese firms to sell overseas.

In such a context, can most of A share companies still grow and improve their performance next year? My answer tends to be rather negative.

Currently, these firms are enjoying the dividend from the inflation: the costs are mainly acquired in the pre-inflation period but the sales are inflated. However, even in such a very favorable market conditions, only 40% of A share companies have grown for the last three years. Some of these growing firms will be affected by the less favorable market condition next year. Furthermore, how can we think those without historical growth will improve themselves in a much more difficult market condition?

### **A major change in my A share portfolio screening model**

In the A share portfolio screening model I have been using since August 2006, I voluntarily excluded any considerations given to the firm growth potential. There were two main reasons behind that choice: 1. I wanted to keep the model as simple as possible; 2. I had an assumption that since the Chinese economy was booming, normally these healthy firms concentrating on their core business should enjoy the growth. The performance of our portfolio during the last year proved that this method worked.

By taking into consideration the G-score, here is the new share screening process:

1. **Annualized ROA>7% in 2007 (I also controlled the ROA in 2005 and 2006).**
2. **Other receivables/Total assets<10%**
3. **Other operating cash inflow/total operating cash inflow<10%**
4. **Other cash outflow investing/Total cash outflow investing<10%**
5. **Non-operating income/sales<10%**
6. **Operating cash flow>0**
7. **G-score>0**

I also changed the rules for entry and exit:

**Buying point:** all shares are picked from those who satisfy all the seven above-mentioned criteria (the total number is 284). If the G-score = 0, the maximum acceptable P/E is 15; if the G-score  $\geq$  50%, the maximum acceptable P/E is 30.

**Selling point:** all shares not satisfying all the seven above-mentioned criteria are excluded. If the G-score = 0, the maximum acceptable P/E is 20; if the G-score  $\geq$  50%, the maximum acceptable P/E is 60.

In the file "Pool.xls", we may see we have currently 39 companies in our new portfolio: among them, 26 have the buying point lower than the price on Nov. 22 and other 13 have the share price higher than the buying point but lower than the selling point.

Best regards,

Yuan