Market developments

The Chinese stock market staged a strong rebound after a relatively weak start to the year. The economy is showing signs of improvement and the overall economic slowdown is not as bad as originally feared. Comments by the premier that there is a floor to economic growth and efforts by the People's Bank of China (PBOC) to reduce the Shibor (Shanghai Interbank rate) further helped sentiment. China was not overly affected by the turmoil in some of the smaller emerging markets. The country's current-account surplus, high foreign exchange reserves and little dependency on external debt, makes China more resilient.

The policy vacuum following the leadership transition and the relatively tight situation in the interbank market that impacted the economy negatively in the first half of the year are easing and projects are restarting. At the same time, the outlook for the global economy is improving. Both manufacturing and non-manufacturing purchasing managers indices (PMI) began to improve in August. Retail sales continue to be strong and inflation is under control.

The stock market had de-rated by the end of June to a level not seen since the global financial crisis. Despite the strong recovery in the third quarter of 2013, the valuation of the market remains very low, while overall allocations to emerging markets and China in particular are close to record lows.

Longer-term developments appear structurally positive, as first steps of the potential reform agenda are being taken. The particular focus is on boosting consumption, expanding tax and fiscal reform, reducing administrative controls and approvals, and the opening the economy for more private investment which in turn should unlock growth-drivers.

Portfolio review

At the end of September 2013, the portfolio held 38 stock positions and 1.5% in cash. The top positions in the fund were China Construction Bank, energy company CNOOC, the Industrial and Commercial Bank of China as well as internet company Tencent.

The new additions to the portfolio were Sunny Optical, Sino Biopharm, Anhui Conch Cement and AAC Technologies. Sunny Optical is the leading camera module and camera lens producer for smartphones in China. It stands to benefit from strong demand growth in smartphones as well as new applications and increasing camera specifications. Sino Biopharm is the one the largest prescription-drug makers in China with leading market shares in hepatitis. The company has a strong sales/marketing infrastructure and a good pipeline (mainly generic drugs). Key drivers for the stock are demographics and expected healthcare growth in China supported by high government budgets. The company is expanding into oncology, analygesic and diabetes. AAC Technologies produces acoustic components for smartphones such as microphones or speakers. We believe that growth in smartphones continues to be strong and that the value of acoustic component per smartphones is going up as it become a differentiating factor between different smartphone models.

We financed the transactions by exiting China Shenhua, as outlook for coal remains unfavourable and earnings growth will not pick up next year. We also exited Trinity – we believe that the business of the company might remain depressed – as well as China Longyuan and China Communications Constructions. We trimmed China Mobile because the stocks we bought have a better risk/reward ratio and a better return profile.

Performance analysis

The Vontobel Fund – China Stars Equity posted a return of +13.1% in the third quarter, while the MSCI China Index returned +12.2% (in US-dollar terms).

The strongest relative performances over the quarter came from the consumer-discretionary sectors. The top contributor was Brilliance China, the local partner of BMW, which reported a very strong first-half result. The oil exploration company CNOOC was the second-best contributor, the company benefited from larger-than-expected increases in oil production.

The biggest drag on relative performance came from our underweights in China Mobile, China Life, Bank of China and Agricultural Bank of China.

Outlook

China is currently in a transition with the focus changing from an economy based on exports and investment to one that is driven by consumer demand and services. The new government seems to be committed to reforms and addressing China's structural problems. It aims to improve the quality of the economic growth rather than the quantity of growth. Measures to curb lavish spending by officials, the regulation of high-risk wealth-management-products and the intervention in the interbank market are steps in the right direction. However, some of the measures will curb GDP growth in the short term while undoubtedly having positive effects on the economy in the long run. Further reform steps were taken to adopt market-based pricing such as gas-pricing reform. The new government also announced a reform to the household registration system (hukou), which will allow around 200 million people to move to cities freely and enjoy social benefits. This measure should further boost consumption.

More details on further government-led reforms will likely come from the third plenary session of the central committee of the Chinese Communist Party in November. We expect measures to drive demand and private consumption such as the introduction of a social-safety net, the abolishment of the one-child policy and the allowance of farmers to monetise land. Furthermore, we expect measures to improve productivity and capital allocation such as the encouragement of private capital investments, further resource-pricing reforms to curb waste and the inefficient use of resources as well as a continued fight against corruption. One important focal point is the improvement in the efficiency of the financial system through liberalising interest-rates. The risk resulting from local-government debt can be resolved by reforming China's tax and fiscal system as there is currently a big mismatch between tax income and spending at the local-government level because most tax are collected by the central government. Direct taxes only account for about 5% of tax revenue in China, compared with 50% in OECD countries.

While the market has strongly de-rated on the back of fears about the economy and the slowdown in the first half of the year as a result of the reform process, it is yet to re-rate and acknowledge the government for the positive long-term impacts of the reforms. Stock-market participants have become too focused on the headline GDP-growth-rate, while we think that the market should centre on the pace of reforms and their potential to improve corporate profitability instead.

Investors should keep in mind that drivers such as higher productivity, improved education and health systems, a growing middle class and changing consumer habits in developing nations remain in place despite occasional let-ups. If China manages the transitions successfully, productivity levels, together with returns on capital, will improve. This should lead to a re-rating of the stock markets. In the short run we expect a) further reforms, b) stabilisation in the growth rate c) improvement in the global economy to be catalyst for the stock market.

The key risks to our investment case are weakness within the global economy, a failure of the new leadership to implement reforms, a sharp rise in inflation or further tightening of monetary conditions.

Important legal information

This document is for information purposes only and does not constitute an offer to subscribe for shares of the Fund. Subscriptions of the Vontobel Fund, an investment fund under Luxembourg law (SICAV), should in any event be made solely on the basis of the current offering prospectus, the Key Investor Information Document (KIID), the articles of incorporation and the most recent annual or semi-annual report (for Italy also the "Modulo di Sottoscrizione") and after seeking the advice of an independent finance, legal, accounting and tax specialist. Interested parties may obtain the above-mentioned documents, as well as the list of changes in portfolio during the year and the list of benchmarks free of charge from the representative in Switzerland: Vontobel Fonds Services AG, Gotthardstrasse 43, 8022 Zurich, the paying agent in Switzerland: Bank Vontobel AG, Gotthardstrasse 43, 8022 Zurich, the paying agent in Austria Erste Bank der oesterreichischen Sparkassen AG, Graben 21, A-1010 Wien, the paying agent in Germany: B. Metzler seel. Sohn & Co. KGaA, Grosse Gallusstrasse 18, 60311 Frankfurt/Main, from the authorized distribution agencies and from the offices of the fund at 69, route d'Esch, L-1470 Luxembourg. They may also download these documents from our website at funds.vontobel.com. The Fund and its subfunds are included in the register of Netherland's Authority for the Financial Markets as mentioned in article 1:107 of the Financial Markets Supervision Act (Wet op het financiële toezicht). In Spain, funds authorized for distribution are recorded in the register of foreign collective investment companies maintained by the Spanish CNMV (under number 280). The funds authorized for distribution in the United Kingdom can be viewed in the FCA register under the Scheme Reference Number 466623. Past performance is not a reliable indicator of current or future performance. Performance data take no account of the commissions and costs charged when units are issued and redeemed. The return of the Fund may go down as well as up due to changes in rates of exchange between currencies.

An investment in a sub-fund of the Vontobel Fund carries various risks which are explained in the sales prospectus. In particular, we wish to draw your attention to the following risks:

Investments in the securities of emerging market countries may exhibit considerable price volatility and – in addition to the unpredictable social, political and economic environment – may also be subject to general operating and regulatory conditions that differ from the standards commonly found in industrialised countries. The currencies of emerging market countries may exhibit wider fluctuations.

Investments in riskier, higher yielding bonds are generally considered to be more speculative in nature. These bonds carry a higher credit risk and their prices are more volatile than bonds with superior credit ratings. There is also a greater risk of losing the original investment and the associated income payments.

Commodity investments can be very volatile and are prone to sudden swings over the long run. Governments may at times intervene directly in certain commodity markets. These interventions can cause significant swings in the prices of different commodities.

Investments in derivatives are often exposed to the risks associated with the underlying markets or financial instruments, as well as issuer risks. Derivatives tend to carry more risk than direct investments.

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