Oberweis
Asset Management

CHINA OPPORTUNITIES MARKET COMMENTARY

3Q 2021

The Quarter in Review

For the quarter ending September 30, 2021, the Oberweis China Opportunities Composite returned -8.68% (-9.03% net of fees) compared to -18.17% for the MSCI China Index, an outperformance of 949 basis points (914 basis points net of fees). Year-to-date, the Oberweis China Opportunities Composite returned -2.71% (-3.65% net of fees) while the MSCI China Index returned -16.67%, an outperformance of 1396 bps (1302 basis points net of fees). While a difficult year for Chinese equities generally, our strategy has fared quite well relative to our benchmark and peers.

In an eventful quarter, China reported slowing economic growth, a flurry of regulatory activity, and rising credit problems. Economic data showed slower growth in the third quarter. Manufacturing PMI contracted to 49.6 in September for the first time since the COVID-19 outbreak, dragged down by weak production and deteriorating labor market conditions. Domestic consumption growth slowed to 2.5% year-over-year (yoy) in August, reaching its lowest level of the past year as personal disposable income growth slowed and cities with sporadic COVID outbreaks experienced partial lockdowns. Growth in industrial output also slowed to 5.3% yoy, below the pre-pandemic level of 6%, partially due to weaker automotive production, which was hurt by the global chip shortage, partly due to a new wave of COVID outbreaks in southeast Asia. Export growth was the only bright spot, growing firmly at 25.6% yoy. As a result of the recent weak economic data, the Chinese GDP forecasted growth rates for the third and fourth quarters of 2021 were revised down to 5.4/4.4% in September from 6.0/5.0% in June, according to Bloomberg's China Economic Forecast Survey. Notably, despite lackluster economic growth, Beijing did not respond with any meaningful fiscal or monetary stimulus. The Chinese central government faces a tricky choice between counteracting slowing economic growth with government stimulus or demonstrating renewed commitment to financial deleveraging and inflation control. For the moment, it seems they have chosen the later.

Perhaps the fastest shift in market dynamics this quarter was on the regulatory front. Obviously, we are at a significant moment in the history of China's economy and capital markets. Beijing is resetting its governance framework --- shifting governance priorities from strictly growth to a balance between growth and sustainability, after a decade-long journey to eliminate absolute poverty. In just a few short months, Chinese regulators launched unprecedented regulations in multiple areas, attacking after-school tutoring, big internet companies, fintech companies, data security and cryptocurrency. All of the new policies focus on three main themes --- common prosperity, financial deleveraging and economic self-sufficiency. Although increased regulation that creates a fair and sustainable playing field may be a positive in the long-run, the arbitrary swiftness created huge short-term uncertainties and volatility in equity prices. Unanticipated regulatory changes, some of which drastically and nearly instantly decimated some industries, triggered investor concerns on China's commitment to free markets. We believe that the peak of new regulatory policies has already passed; as investors gain more clarity, we believe that expectations will be reset accordingly. Investors will surely discount the uncertainty for a period of time, but we do not think it will remain indefinitely as seen in countries like Russia and Argentina.

As if this were not enough, a high-profile credit default in China took the spotlight this quarter. Bond defaults have been on the rise in China in recent years, a biproduct of Beijing's commitment since 2017 toward reducing financial leverage and punishing those who use it excessively. Overall, China's defaults have been manageable to date and have had no systematic impact on the economy. The number of defaults this year appears to be occurring at a similar pace to last year. But a few larger idiosyncratic cases have attracted wide attention. Evergrande is the poster child. Evergrande is one of the largest property developers in China in terms of annual contract sales. This business expanded rapidly in recent years, apparently too rapidly. Evergrande's excessive leverage has caught up to it, and the company has been mired in a default crisis since the end of 2020. With total debt of USD $110 billion, Evergrande was previously assumed to be "too big to fail," even amid a failure to make recent interest payments. Astonishingly, the central government decided not to save the company and let it default, signaling Beijing's resolve to not rely on the property sector for stimulus going forward. Despite the newspaper headlines, we expect that Evergrande's default, while painful to some, probably will not cause systematic stress in China. With multiple rounds of stress testing under its belt prior to tightening regulations in 2020, we anticipate that Beijing made a calculated bet that the economy would not face systemic risk from Evergrande's default, and that the government is now very much focused on inoculating against contagion instead of bailing them out. While Evergrande was the highest profile default to date, it's not the first. For example, China smoothly navigated the restructuring of Fortune Land and Hainan Airline Group (HNA) and our base case is that Evergrande's demise will not be a material adverse driver in China's economy over the long term.

AVERAGE ANNUAL TOTAL RETURNS ***(as of September 30, 2021)***

	QTD	YTD	1 Yr	3 Yr	5 Yr	10 Yr	Since Inception 10/1/2005
China Opportunities (gross of fees)	**-8.68%**	**-2.71%**	**13.44%**	**22.14%**	**18.12%**	**17.42%**	**15.52%**
China Opportunities (net of fees)	**-9.03%**	**-3.65%**	**12.24%**	**20.82%**	**16.81%**	**16.08%**	**14.12%**
MSCI China Index	-18.17%	-16.67%	-7.33%	5.95%	9.12%	8.68%	9.69%

Past performance is not necessarily indicative of future results. Performance is historical and includes the reinvestment of dividends and other income. Unusually high returns may not be sustainable. The strategy invests in rapidly growing smaller and medium-sized companies that may offer greater return potential. However, these investments often involve greater risks and volatility. Foreign investments involve greater risks than U.S. investments, including political and economic risks and the risk of currency fluctuations. Advisory fees are disclosed in Part II of Form ADV.

Oberweis Asset Management, Inc. ("OAM") is an independent investment management firm that is not affiliated with any parent organization. The composite returns are comprised of all fully discretionary accounts with a minimum value of $5 million. Performance results, from 10-1-05 until 10-1-06 as well as 5-1-08 to present, are derived solely from the performance of the Oberweis China Opportunities Fund, a registered, open-end mutual fund, for which OAM serves as investment adviser. Accounts are dollar-weighted within the composite and reported in U.S. dollars.

The MSCI China Net Index is a free float-adjusted market capitalization-weighted Index of Chinese equities that include China-affiliated corporations and H shares listed on the Hong Kong Exchange, and B shares listed on the Shanghai and Shenzhen exchanges and P chips and foreign listings with minimum dividends reinvested net of withholding tax.

Oberweis Asset Management (Hong Kong) Limited ("OAMHK"), is a subsidiary of OAM and is organized under the laws of Hong Kong and licensed by the Hong Kong Securities and Futures Commission. OAMHK has entered into a sub-advisory agreement with OAM to provide research services and portfolio management with respect to OBCHX.

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Outlook

Looking forward, slower economic growth and a tighter regulatory environment will continue to dominate Chinese equity markets in the near term. It is a difficult task for Beijing to balance economic growth and sustainability under the triple constraints of common prosperity, financial deleveraging and carbon neutrality. All three targets are not growth-friendly in the near term. To contain the influence of technology giants, Beijing has to take measures to slow down the pace of companies in fast-growing sectors like E-commerce, fintech and cloud computing. To lower financial leverage, Beijing has decided to abandon the property sector as a stimulus tool as evidenced by the way it dealt with the Evergrande default crisis. Without meaningful stimulus in the property sector (about 20% of Chinese GDP), we don't see much upside on China's economic GDP growth in the near term. To reduce carbon emissions, the government has aggressively cut production of high-energy intensity sectors, which has significantly lowered industrial output in sectors like chemicals, mining and metals in recent months. All these measures are hurting economic growth in the near term, though perhaps net positive for long-term growth. This does not mean that China does not care about economic growth anymore; the government still needs a reasonable level of economic growth for high employment and social stability. For example, Beijing has told local government officials that carbon neutrality is a long-term goal, which should be integrated into short-term economic growth and should not disrupt normal industrial production. Although it did not save Evergrande, Beijing is encouraging banks to lend to property developers with healthy balance sheets. Despite slower economic growth and regulatory uncertainties, we continue to see strong flows into Chinese equities from foreign investors. For example, during the quarter, more than USD 10bn flowed into A-shares from southbound investors (ie Hong Kong). After the recent sell-off, valuations of Chinese equities are attractive. The forward 12-month price-to-earnings ratio is at 12.9x with earnings growth of 23/13% in 2021 and 2022.

As for our strategy, we continue to focus on misunderstood companies undergoing positive fundamental changes when we believe such changes have not been fully understood by the market yet. We look for niche-oriented companies whose success is more predicted on product success, technology innovation, regulatory changes, and the evolution of new markets in China. In the quarter, we found new ideas in the petrochemicals, materials and information technology sectors. Generally, these companies are leading players in niche markets whose growth is more predicated on product acceptance than on overall GDP growth. Many of these ideas are beneficiaries of the ongoing structural economic and social changes occurring in China.

Portfolio Highlights

During the quarter, the portfolio was 99.8% invested in 88 companies. The biggest performance contributors were materials, consumer discretionary and information technology.

On the contrary, our biggest performance distractors were financials, health care and real estate.

Organization Update

There was no change to the team during the quarter.

Oberweis Asset Management's Investment Phillosophy

We believe that investing in smaller companies driving revenue and earnings growth in excess of expectations results in superior investment performance over long periods of time. We believe that innovation is the key to economic growth and wealth creation and are committed to investing in companies at the forefront of innovation – smaller company stocks that offer the potential for extraordinary revenue and earnings growth.

The entrepreneurial spirit is alive and well at these companies. Many are nimble and uniquely address the needs of their customers with patented new products and services. Successful investing, however, demands more than finding companies with good growth prospects. We must also buy these stocks for our clients at prices that make sense. By paying careful attention to companies' valuations in relation to expected earnings growth rates, we seek to purchase stocks when they still have considerable appreciation potential.

For more information please contact:
Brian K. Lee, Director of Marketing & Client Service
(800) 323-6166 | (630) 577-2321 | brian.lee@oberweis.net

Marc Carlson, Director Marketing & Client Service
(800) 323-6166 | (630) 577-2364 | marc.carlson@oberweis.net

Oberweis Asset Management, Inc.
3333 Warrenville Rd., Suite 500, Lisle, IL 60532