

# Templeton Dragon Fund: Bullish Exposure To Beaten Down Chinese Stocks

Jun. 25, 2021 5:19 AM ET | **Templeton Dragon Fund (TDF)** | CAF, CHN, MCHI... | 12 Comments | 7 Likes

## Summary

- TDF invests primarily in stocks from China.
- The segment has been under pressure in recent months amid broader market volatility and concerns over geopolitical and regulatory risks.
- We are bullish on TDF at the current level following the recent correction, highlighted by the overall positive macro outlook.
- TDF distributes a semi-annual dividend that, we estimate, yields +8% on a forward basis.
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The **Templeton Dragon Fund** (NYSE:[TDF](#)) invests in stocks across companies from China and other Asian countries through a closed-end structure. This is a segment that delivered strong gains in 2020 with TDF returning 52% last year which follows a long history of outperforming region benchmarks highlighting the quality and attraction of this actively managed CEF. That said, 2020 has been more difficult with Chinese stocks facing a large selloff from recent highs considering relative weakness among high-growth tech and new uncertainties related to the regulatory environment. Still, with TDF down about 15% off from levels in Q1, we are bullish and view this correction as a buying opportunity with the fund as a good option to gain diversified exposure to a group of leading stocks with a positive long-term outlook. Income investors should also be attracted to TDF's managed dividend distribution that offers a forward yield we estimate to be around 8%.

## TDF - Templeton Dragon Fund

**23.10** 0.27 (+1.18%) 12:30 PM 06/24/21

NYSE | 15 minute delayed price



(Seeking Alpha)

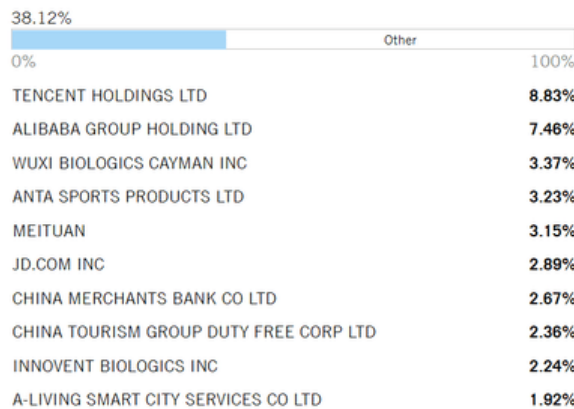
## TDF Background

According to the fund strategy, TDF seeks long-term capital appreciation by investing at least 45% of its total assets in Chinese companies. While the strategy allows for investments in equities from other countries, the current portfolio is exclusively in Chinese stocks which is consistent with the portfolio manager's discretion and flexibility.

Currently, the fund is allocated across a relatively concentrated 41 issuers, mostly large-cap holdings, with the top 3 positions in Tencent Holdings Ltd ([OTCPK:TCEHY](#)), Alibaba Group Holdings Ltd (NYSE:[BABA](#)), and WuXi Biologics Inc. ([OTCPK:WXXWY](#)) together representing about 20% of the overall portfolio. Down the list, other notable names include e-commerce giant JD.com (NASDAQ:[JD](#)), food delivery leader Meituan ([OTCPK:MPNGF](#)), and Baidu Inc. (NASDAQ:[BIDU](#)). With a clear tilt towards consumer discretionary tech, there are representatives across several sectors and industries.

#### TOP TEN HOLDINGS<sup>4, 5</sup>

As of 05/31/2021



#### SECTOR BREAKDOWN

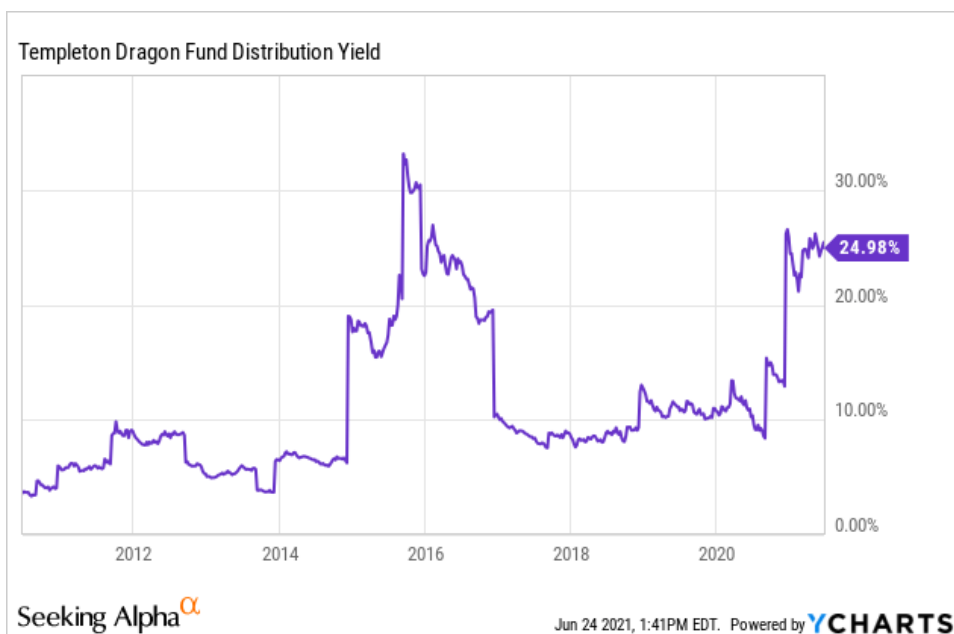
As of 05/31/2021



(source: [Franklin Templeton](#))

## TDF Pays A Semi-Annual Distribution

TDF traditionally pays a dividend on a semi-annual basis in September and December of each year. The current stated yield on TDF of 25% is based on an exceptionally large distribution in 2020 when the fund paid out \$5.78. The amount reflects realized gains considering the strong market performance into the second half of last year. In other words, while TDF does not have a stated dividend policy, the fund typically distributes nearly all of its investment income and long-term capital gain as a result of its regular portfolio turnover.



Data by **YCharts**

While the 2021 distribution has not yet been announced, we believe the actual per-share amount will be lower compared to 2020 given the muted returns for the fund thus far this year. We forecast a payout closer to \$2.00 per share for 2021 implying a yield between 8% and 10% which is more consistent with historical trends. We expect the next dividend to be announced in late August.

#### Consolidated Financial Highlights

	Year Ended December 31,				
	2020	2019	2018	2017	2016
<b>Per share operating performance</b>					
(for a share outstanding throughout the year)					
Net asset value, beginning of year	\$21.81	\$19.01	\$24.53	\$19.05	\$20.51
Income from investment operations:					
Net investment income (loss) <sup>a</sup>	(0.06)	0.19	0.32 <sup>b</sup>	0.19	0.27
Net realized and unrealized gains (losses)	8.96	4.70	(3.76)	6.98	(0.06)
Total from investment operations	8.90	4.89	(3.44)	7.17	0.21
Less distributions from:					
Net investment income	(0.16)	(0.30)	(0.21)	(0.34)	(0.29)
Net realized gains	(5.62)	(1.79)	(1.90)	(1.37)	(1.41)
<b>Total distributions</b>	<b>(5.78)</b>	<b>(2.09)</b>	<b>(2.11)</b>	<b>(1.71)</b>	<b>(1.70)</b>
Repurchase of shares	—	— <sup>c</sup>	0.03	0.02	0.03
Net asset value, end of year	\$24.93	\$21.81	\$19.01	\$24.53	\$19.05
Market value, end of year <sup>d</sup>	\$23.36	\$19.45	\$17.00	\$21.51	\$16.38
Total return (based on market value per share)	52.46%	27.55%	(11.87)%	42.06%	1.03%

(source: [Franklin Templeton](#))

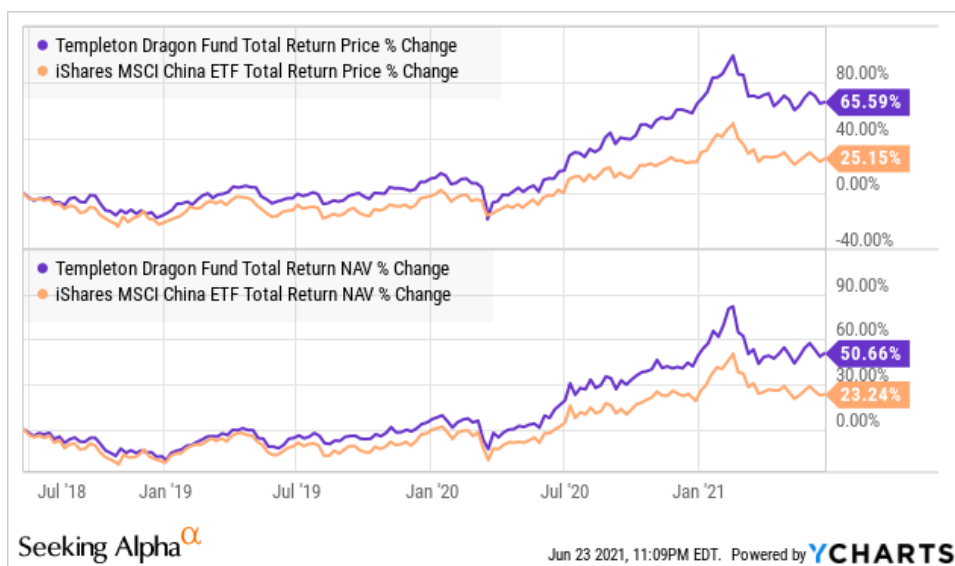
TDF Outperforms Its Benchmark

TDF has a strong track record that goes back to the fund's inception in 1994. While the actively managed strategy means TDF is not meant to track any particular index, the fund is using the MSCI China All Shares Index as a benchmark a reference to track returns. With official fund data as of the last quarter-end, TDF has outperformed the MSCI index by a wide margin over the past decade.

TDF Templeton Dragon Fund, Inc.				
PERFORMANCE				
AVERAGE ANNUAL TOTAL RETURNS <sup>1, 2, 3, 4, 5</sup> ⓘ				
As of 03/31/2021				
Average Annual Total Returns				
MONTH END QUARTER END				
QUARTER END As of 03/31/2021	1 YR	3 YR	5 YR	10 YR
NAV (%)	56.36	13.53	17.09	8.16
Market Price (%)	75.64	18.73	20.91	9.83
MSCI China All Shares Index-NR (%)	45.82	8.52	13.10	6.75
MSCI China Index-NR (%)	43.61	8.24	16.09	7.26

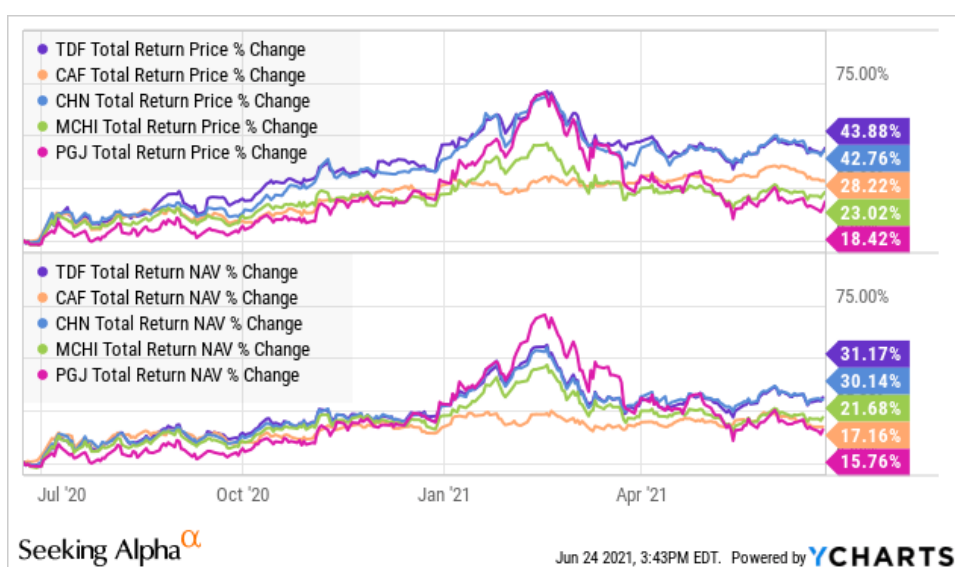
(source: Franklin Templeton)

Using the iShares MSCI China ETF ([MCHI](#)) which is the largest exchange-traded fund for Chinese stocks, we note that TDF has returned 65.6% over the past 3-years compared to 25.2% from MCHI at its market price. Similarly, the NAV total return at 51% over the period confirms that the performance has been based on the underlying portfolio performance and a reflection of the manager's stock selection skill by delivering alpha.



Data by YCharts

To further the point we highlight that TDF with a 44% total return at the market price over the past year has also outperformed a group of alternative CEFs in the segment being the Morgan Stanley China A Share Fund (CAF) with a 28% return, while the China Fund (CHN) with a 43% return was close. There is also the Invesco Golden Dragon China Portfolio ETF (PGJ) which has lagged the group with an 18% return in the last year.



Data by YCharts

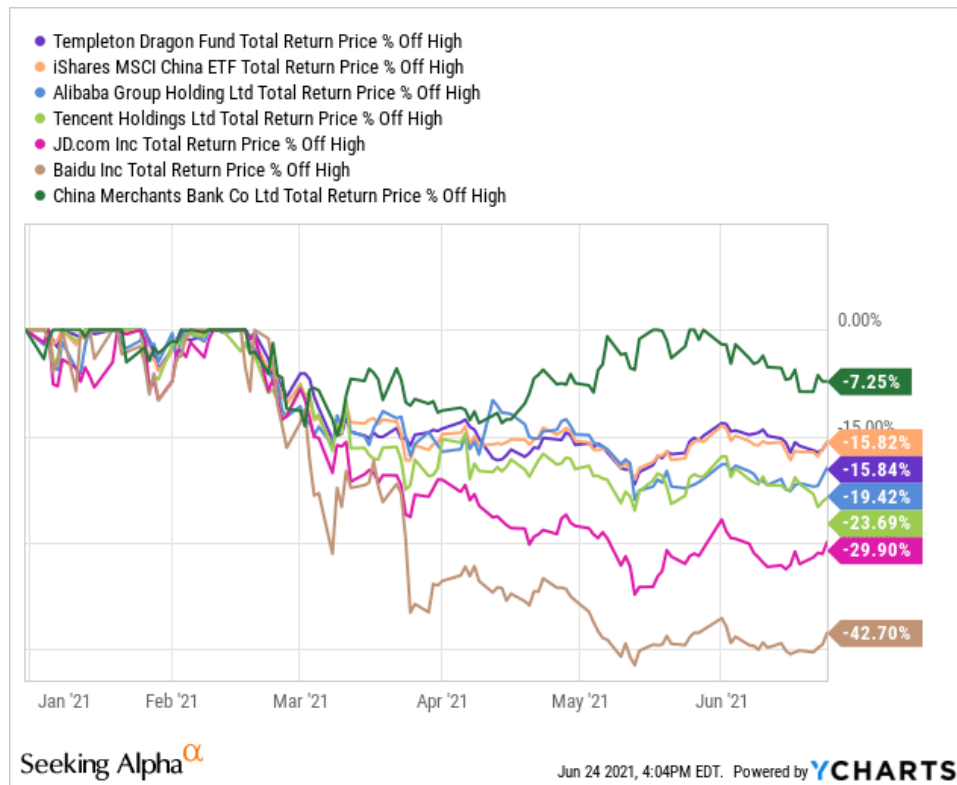
## Chinese Stocks Weakness in 2021



As mentioned, 2021 has been more a difficult year with TDF down about 1% year to date, underperforming global stock market indexes considering the S&P ([SPY](#)) has climbed about 14%. Looking back into early in Q1, following what was a strong rally among tech and high-growth names including the underlying portfolio of TDF, the segment sold off around mid-February. TDF is down 16% from its high matching the performance in the MSCI China ETF.

Several of the key stocks in the portfolio have been pressured even lower considering Baidu is down 43%, while JD.com, Tencent Holdings, and Alibaba Group are all effectively in a bear market down 20% or more. There are several dynamics at play to explain the volatility in this group. It follows a broader global theme of a sharp selloff amid high-growth momentum names in Q1 from themes like clean-energy and electric vehicles where an argument can be made that valuations reached extreme levels setting up a pullback. In many ways, the setup was a rotation out of "pandemic winners" into a post-COVID recovery name.





Data by YCharts

A development that made headlines in Q1 was reports of a major liquidation by [Archegos Capital](#), and an investment fund forced to sell over \$20 billion in leveraged bets concentrated among some high-profile stocks including Baidu as the market turned lower. Indications are that as the banks unwound positions, there was some selling contagion pressured related stocks lower as a catalyst for the larger selloff.

There are also concerns related to the implementation of the "Holding Foreign Companies Accountable Act" which was signed into law in December 2020. The law requires foreign companies publicly listed in the U.S. to declare they are not owned or controlled by any foreign government. The uncertainty here is how much access and transparency Chinese companies are willing to grant auditing firms approved by the Public Company Accounting Oversight Board. The framework is still in the process of [final amendments](#).

While it's assumed "blue-chip" Chinese firms are in accordance with all laws and regulations, the impact on smaller companies could be more significant dealing with higher accounting standards. Early this month, President Biden issued an executive order titled "Addressing the Threat from Securities Investments that Finance Certain Companies of the People's Republic of China" in an effort to limit funding of companies that could pose a security threat. The fund manager Franklin Templeton has confirmed that TDF does not hold any investments identified as affiliated with the Chinese military.

Furthermore, as recently as this week, the Biden administration took steps to [ban imports](#) of solar photovoltaic products manufactured in the Chinese of Xinjiang citing while blacklisting some Chinese firms. As it relates to the TDF fund, the point here is that the environment of more uncertainty towards relations with China has resulted in weaker sentiment towards the Chinese stocks overall.

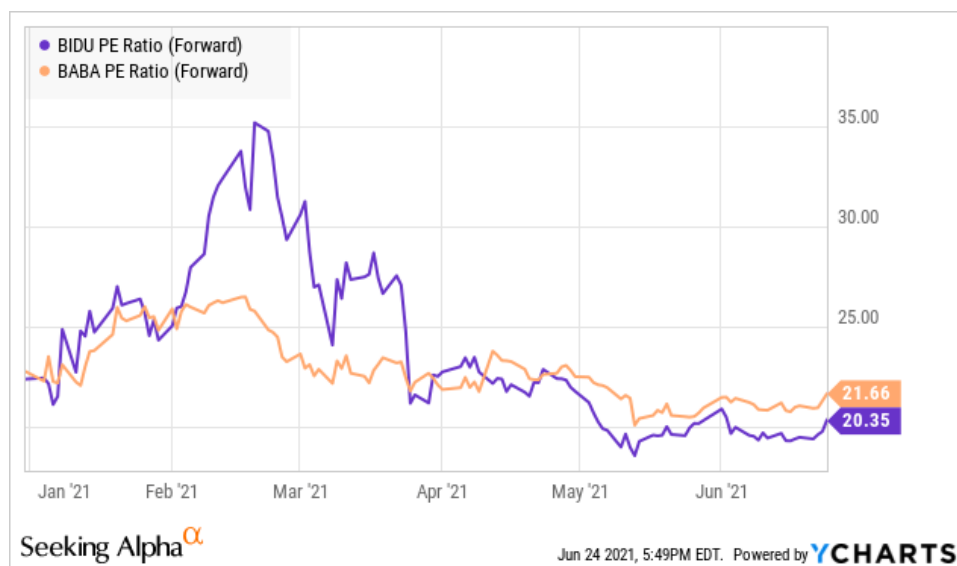
## **The Glass is Half Full**

While recognizing the ongoing risks, we're taking a more optimistic view towards the outlook with a belief that the selloff has already more than discounted the potential impacts while the underlying companies have real value. Beyond certain industries like the Chinese banking and state-owned enterprises that are potentially problematic, our take is that for the majority of Chinese companies that operate within China and have otherwise limited exposure to the U.S. directly, it remains business as usual.

Just among some of the key stocks within TDF, the attraction here comes down to the strong growth and long-term earnings outlook. Looking just at consensus revenue estimates for the year ahead, the companies TDF is invested in are benefiting from what remains a positive macro and global growth outlook including ongoing momentum in the Chinese economy.

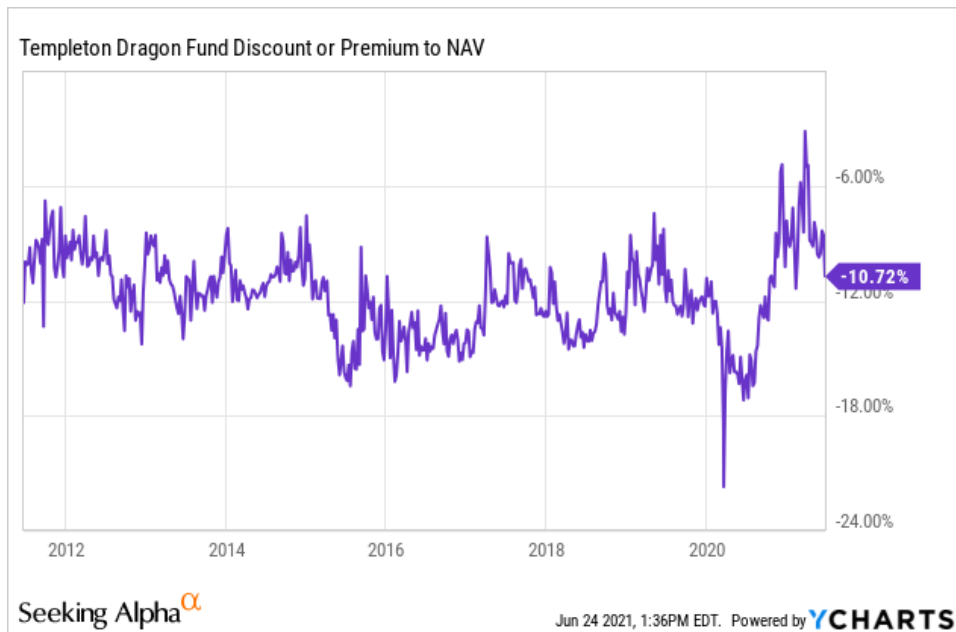
Weight in TDF	Company Name	Consensus 2021 Revenue Growth y/y
8.8%	Tencent Holdings Limited ( <a href="#">OTCPK:TCEHY</a> )	24%
7.5%	Alibaba Group Holding Ltd ( <a href="#">BABA</a> )	29%
3.4%	WuXi AppTec Co., Ltd. ( <a href="#">OTCPK:WXXWY</a> )	62%
3.2%	ANTA Sports Products Ltd ( <a href="#">OTCPK:ANPDF</a> )	38%
3.2%	Meituan ( <a href="#">OTCPK:MPNGF</a> )	61%
2.9%	JD.com ( <a href="#">JD</a> )	28%

From a high level, the companies will with exposure to the Chinese consume will benefit from the China's projected 8.4% GDP growth this year, well ahead of developed and other emerging markets. The correction in the key stocks that are in the TDF portfolio have helped to reset valuations lower to more attractive levels. Alibaba and Baidu both trading at a forward P/E of around 21x are now at a discount compared to historical valuation averages which is a theme across the group.



Data by YCharts

Finally, we note that the fund's current discount to NAV at 11% is near the long-term average for TDF of 12% over the past decade. This suggests the fund is reasonably priced on a relative basis against the spread investors have achieved historically. While there are many reasons to explain a widening or narrowing of the pricing discount, our take is that the poor overall sentiment towards Chinese stocks and modest returns in 2021 have thus far limited the appeal of the fund in the current environment. To the upside, a case can be made that stronger performance and improving sentiment going forward would drive a narrowing spread and further adding to shareholder's return potential.



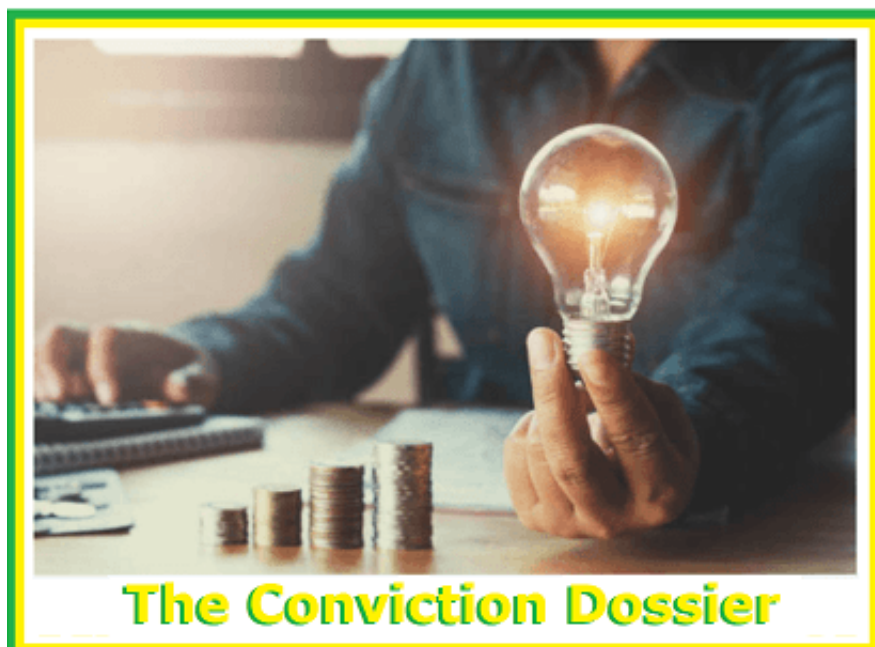
Data by [YCharts](#)

## Final Thoughts

Overall we are bullish on the Templeton Dragon Fund which checks off all the marks for what makes a quality CEF being its strong history of long-term outperformance to its benchmark, generous distribution yield, and positive outlook for the underlying investment strategy. We see value in Chinese stocks following the selloff this year as the country maintains positive macro tailwinds with strong growth.

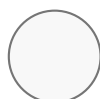
The risk here comes down to what would be a concerning deterioration to the global growth outlook. Weaker than expect economic indicators out of China including consumer spending as a key monitoring point could pressure stocks with renewed bearish sentiment. Investors should also be aware of ongoing regulatory and geopolitical risks as headlines adding to uncertainty can generate volatility. We believe TDF works best in the context of a broader diversified portfolio.

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This article was written by



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**Disclosure:** I am/we are long TDF. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

7 Likes

12 Comments



## Comments (12)

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**clrodrick**

Yesterday, 6:10 PM



Comments (11.58K) | + Follow

TDF is always a fund that is on my buy radar but just never gets bought. I think you're right that TDF is set to outperform I need to figure out a way to add it

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**BOOX Research**

Yesterday, 9:54 AM



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**BantalInvestor**

Yesterday, 9:48 AM



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It's worth noting that Bill Gates bought 25 million shares several years ago.

➤ Reply   👍 Like (1)



**fujilomi**

Yesterday, 8:55 AM



Comments (7.71K) | + Follow

Thanks for the article. TDF is my go to China fund, but currently in a rough patch with a bearish MACD crossover. Hopefully getting better, just broke over the 50 day MAV. *(edited)*

➤ Reply   👍 Like (1)



**BOOX Research**

Yesterday, 9:48 AM



Marketplace Contributor

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Comments (2.75K) | Following

Author's Reply @fujilomi this is the time to buy/ add.. a lot of Chinese stocks turning the corner.. good luck

↩ Reply   👍 Like (1)



**galicianova**

Yesterday, 5:33 AM



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well, there are other CEFs investing in China with a better performance not to mention that the current managers of the fund are new so funds past performance is irrelevant!

↩ Reply   👍 Like (1)



**BOOX Research**

Yesterday, 10:00 AM



Marketplace Contributor

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Comments (2.75K) | Following

Author's Reply @galicianova there are a couple of other CEFs with a broader "Asia" theme but only \$TDF, \$CHN, \$CAF are "China" focused equity funds.. I also like \$FAX on the bonds side.

↩ Reply   👍 Like



**galicianova**

Yesterday, 10:31 AM



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@BOOX Research and Chn is definitely better thn TDF, mattews are experts on china affairs

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**BOOX Research**

Yesterday, 10:38 AM



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**Author's Reply** @galicianova CHN and TDF have a similar profile, they should both do well if Chinese stocks rally

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**fujilomi**

Yesterday, 11:21 AM



Comments (7.71K) | + Follow

@galicianova Discount to NAV and 12 month total return pretty close for CHN vs TDF according to CEF Connect.

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**sc21**

Yesterday, 10:03 PM



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@BOOX Research

when you say the two funds have a similar profile ,what exactly do you mean? thanks sc

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**BOOX Research**

Yesterday, 11:34 PM



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**Author's Reply** @sc21 in this case just a lot of similarities.. both TDF and CHN have around 50 holdings, mostly large-cap China region stocks.. Alibaba/ Tencent a top holding for both funds.. CHN higher tilt towards Chinese banks/ TDF more consumer discretionary and tech (*edited*)

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