



Views from the Far East Part Two: China

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Herein the long awaited second instalment following our trip to Asia. Here, we focus on China.

Enter the Dragon

In Chinese mythology, the dragon's appearance is described as having the body of a snake, a fish's tail, the antlers of a stag, a camel's face, eagle's talons, bull's ears, tiger's feet and the eyes of a demon. China itself is just as diverse, especially in terms of geography and culture. Flying west across China, the window seat afforded me a great view over the changing landscape. China is sub-arctic in the north and tropical in the south and includes such diverse regions as the Gobi desert and the Himalayas. Culturally, the Chinese consist of at least 50 ethnic groups speaking around 13 dialects and languages. It is important to remember this diversity when considering investment in China. So as we approached Shànghǎi, I struggled to learn some rudimentary Shànghǎinese (yes, it's a language), and I wondered what to make of the big scary dragon.

“Shànghǎi is like the emperor's ugly daughter; she never has to worry about suitors” (old Chinese saying)

Shànghǎi is not only the financial centre of China but also a veritable ground zero for the country's booming economy. This is a city in a hurry to get somewhere. The city has just overtaken Singapore as the world's busiest sea port, and seeing all the container ships from the air, it is tempting to wonder if the dragon might eventually gobble up the world's entire stock of natural resources and food.

It is easy to get swept along by the growth and euphoria in China, and to infer that this must mean significant investment opportunities. However, fast growth does not always benefit investors. It is often better to search for imbalances, distortions and pockets of inefficiencies, which tends to offer better opportunities. In addition, you only have to try to cross the street in Shànghǎi to be reminded that with speed comes inherent risk, as bicycles and scooters do their best to run you down. Many commentators would have you believe that all the old risks have ebbed away with the reforms since the 1970s, but whenever there are excessive returns on offer, there is always extra risk. So as I fought my way through the crowds towards my first meeting, I wondered how investors have fared in recent years.

Confucius says: Life is really simple, but we insist on making it complicated

Looking back over the past 10 years, China is a textbook example of how stockmarkets do not follow economic performance. The economy has grown at an astounding average compound rate of between 9-10%, yet the stockmarket, as measured by the MSCI China index, has lost 6%. It's true that the MSCI China index only represents part of the market, so it is somewhat misleading. The opportunities for active management have certainly been there. One hedge fund manager I met with has just notched up a 70+% return for 2006. However, it is also true that the volatility and underperformance experienced in the stock market has been a result of the dominance of state owned enterprises and the uncertainty regarding the share ownership structure. Here is not the right place to discuss the details in terms of A shares, B shares, H shares, red chips, domestic investor quotas, foreign investor quotas, limited ownership and so on, but the good news is that the system is headed for greater simplicity. The inefficiency of the capital market has been detrimental to China's economy, and the government has learned its lesson. So if that explains the stockmarket performance, what has driven the economic growth? What has the dragon been feeding on?

Dragon fodder 1: Exports

The reforms and modernisation required for China to join the World Trade Organisation (WTO) over the last 5 years have catapulted the nation into global spotlight, attracting huge foreign and domestic investment. Cheap and abundant labour combined with growing infrastructure have created a manufacturing sector that has excelled in the global market. China has clearly benefited from the lifting of trade barriers, with exports continuing to grow at 30% year on year.



Dragon fodder 2: Domestic consumption

Domestic consumption has grown rapidly, and now accounts for 40% of GDP. The lion's share of the consumption has been done by the 100 million people living in the cities and coastal areas and spending is mainly done by middle class 30-40 year olds. Hence the consumption boom is only really a fraction of the potential, and growth has not kept pace with GDP growth over the last few years. The Chinese people are culturally savers, and the savings rate is currently around 45%. However, it is expected that consumption growth will accelerate as wages rise, social security increases, taxes fall and access to credit expands.

Dragon fodder 3: Investment

Admission to the WTO has also attracted huge foreign and domestic investment. Despite there being massive overinvestment in China, meaning low returns on capital, this has assisted in providing much of the infrastructure to facilitate expansion.

The government's dodgy abacus

Whichever way you look at it, China's growth rate has been stunning. Consensus used to be that the Chinese government's growth statistics were too high, but now many are of the opinion that the numbers are too low. The statistics are clearly massaged, but it is more likely that they are adjusted to suggest greater stability of growth than a consistent distortion one way or another. Whatever the truth, the growth trend is very positive. So there is plenty to be enthusiastic about.

Double happiness

During my time in Shanghai, I would come to experience overwhelming enthusiasm from most of the Chinese fund managers I met. It is incredibly difficult to separate the Chinese optimistic view of the world from the reality, and even more difficult to establish whether there is a difference. I would find that in many cases that my questions about the risks of investing in China were met with suspicious looks, as if these were trick questions.

I wondered if the excessive zeal could be explained. Later on in my trip, whilst hiking in the hills of the new territories in Hong Kong, I chatted with some Chinese students and their mentor fund manager about the characteristics of the Chinese people. The students were born of China's one child family regime. It was time to play amateur psychologist and suggest that children without siblings tend to be more competitive than those with brothers or sisters, and are less likely to admit being wrong. So does Miss Wong always have to be right? It is hard to imagine that this has not had an effect on the nation's psyche, coupled with the effects of the Cultural Revolution in 1949. So as I walked closer to a cliff edge overlooking the Pacific I wondered that if overzealousness is not a risk to China, then what is. What could slow down or even slay the dragon? And what risks do foreign investors face.

Dragonslayer 1: Global Slowdown

Confucius says: It does not matter how slowly you go, so long as you do not stop

A global slowdown would of course cause a slowdown in China, but the extent of the link is less well understood. In terms of the US, the Chinese economy has become less directly linked in recent years as US bound exports now account for only 25% of the total. Proponents of a soft landing suggest that US interest rates will fall in 6 months time and Asia will not see much impact. In the past, when everything has gone wrong at once (1989, 1998), China has slowed to around 6% annual growth on a 5 year average basis. Today the structure of domestic demand is healthier, so the next cyclical slowdown should be shallower than the last.

In addition, the rest of the world would not enjoy a slowdown in China. It represents only 4% of global GDP, but drives 17.5% of worldwide GDP growth, more than the US contribution. China's holdings in US treasuries suppress US interest rates and therefore support US consumption. Low priced Chinese exports increase US consumers' buying power. More than ever, China matters to the global economy.

Dragonslayer 2: Capital controls

Confucius says: One should not be planning a divorce before a marriage

Putting money into China is relatively easy, getting money out is less so. China only recently passed a new bankruptcy law due, to be implemented in July. Hence the courts are inexperienced in this area, a key point to remember in the event of a recession, when bankruptcy would be rife. At present the claims of foreign creditors are subordinated to local claims. Assets of a distressed company are usually frozen on a first come first served basis, and laws are largely influenced by local parties and vested interests. In addition, foreign exchange laws are also very strict, a further barrier to repatriating international investor's cash. Although there are positive moves, such as the increase in quotas to allow greater foreign investment in A shares, and laws to allow faster repatriation of capital, overall the legal system would not leave a Gweilo like me in a good position in the event of a sharp downturn.



Dragonslayer 3: Damn property rights

The concept of property rights will always be questionable in a country that is still a one party state. This is most dramatically evident in the case of the three gorges dam, due to be completed in 2009, the largest hydroelectric dam in the world. The dam shows how centralisation can help when growth plans are ambitious, but the project has displaced more than a million people along the Yangtze River so far. The success of the project means that it may prove a model for further big dam projects, and this sets a concerning precedent. There is no reason to expect the rights of other groups will be protected if they stand in the way of China's rush to expand.

Dragonslayer 4: Protectionism

Confucius says: What you do not want done to yourself, do not do to others.

China's exports have flourished on the world stage. China is the world's third biggest exporter, although much of that is just throughput from other countries in Asia. The standard defence other countries use against the onslaught of Chinese exports is to accuse China of dumping goods to gain market share. If exports were to continue to expand rapidly, this could provoke intensified resistance from other countries.

Dragonslayer 5: Overheating

Confucius says: He who will not economise will have to agonise.

The Chinese economy faces a clear risk of overheating. Growth in 2006 is expected to be around 10% again although moderate slowing is expected in 2007 due to slower export growth and policy tightening. However, monetary tightening is difficult to implement because much of China's investment is financed by companies themselves, and foreign capital adds to the excess liquidity. Hence interest rates have risen, the currency has been allowed to appreciate, and direct controls on banks and local authorities have been exercised. However, on the positive side, there are no signs of inflationary pressure yet, and the government has the added advantage of being able to set the prices of key products and commodities.

Dragonslayer 6: Inequality

Confucius says: In a country well governed, poverty is something to be ashamed of. In a country badly governed, wealth is something to be ashamed of.

China has done well to reduce poverty, with the rate falling from 16% of the population to around 10% since 2001. However, the poorest 10% have become poorer. It is important to remember that in China, 10% of the population means 130 million people, who are desperately in need of welfare. The government are rightly focused on trying to reduce the inequality as it is one of the main threats to political stability. Efforts to tackle the inequality are motivated by fear of unrest. The example of Russia's collapse is still in the mind, as is the example of Latin America, where income inequalities and the rush to privatise too quickly have caused economic and political problems. However inequalities are not solved easily and corruption does not help. The government has made changes to spread the benefit of China's expansion to the rural areas via President Hu's vision of a 'harmonious society', which involves providing medical insurance, education benefits and the abolition of the agriculture tax. The government knows that it was, after all, a peasant revolution that led the communists to power in the first place.

Dragonslayer 7: The bank sector and credit risk

The major Chinese banks have been the weak link in the Chinese economy, receiving \$400bn in bail outs from the government since 1998. There are rumours that the banks are piling up more and more non performing loans, and the flow of credit cannot be turned off due to the effect on the economy.

It is true that there is a massive over concentration of financial assets in the banking system. Over reliance on banks contributed directly to the Asian financial crisis of the late 1990s when far too much power lay in the hands of the state banks. However, for China, the WTO accession has meant an opening of the sector to foreign lenders and their presence is helping to drive bank reform.

Ultimately, only two things matter in the assessment of China's financial system risk: the rate of GDP growth, and the rate of improvement in credit quality. As long as GDP growth remains high and credit quality continues to improve, there should be no cause for concern. Although the economic outlook looks bright, the credit quality improvement rate has been questionable in recent years, and this represents a serious concern, and one of the more significant threats to China's success.

Many point to the government's \$1,000bn in foreign reserves to plug the gaps. Indeed, in 2004 and 2005 the People's Bank of China used \$60bn to write off bad debts. However the government is restricted in its ability to spend reserves in China because it involves converting the foreign currency into renminbi, which exerts upward pressure on the exchange rate. The central bank then has to buy back foreign currency to hold the renminbi down, and the reserves rise again. The government is now allowing currency appreciation, but this carries its own issues.



Dragonslayer 8: The renminbi

The government are committed to allowing the renminbi to appreciate between 3% and 5% pa over the next few years. This will help let air out of the over-inflated economy, but exporters may well be hit hard by losing competitiveness on the world market. Many exporters operate on very low margins, so the appreciation must be managed gradually. Labour productivity is rising rapidly which offsets the squeeze in margin, but hundreds of millions of Chinese are supported directly or indirectly by the export industry. The currency's appreciation has accelerated over the last few months, rising almost 7% annualised against the dollar since September. The government must know that it treads a fine line between allowing controlled renminbi appreciation to dampen the economy and satisfy political issues, and the threat of mass bankruptcies in the export sector and resultant impact on millions of Chinese workers.

Dragonslayer 9: The risk of Hu and Wen!

Political risk has fallen in recent times. The country has shown resilience in the face of potential catastrophes such as the Asian financial crisis, the end of the dot com boom, the recession in the US and SARS. In addition, the government has provided a relatively stable political environment, reforming state enterprises, increasing labour productivity, whilst limiting social problems. The government is also making noise to tackle corruption as well, with the arrest of Shanghai party leader Cheng Liangyu and other high profile heads, serving as a warning to others. President Hu Jintao and Premier Wen Jiabao need to continue political reform to make stable transition to democracy, and we can be sure nothing controversial is likely to happen before Beijing Olympics in 2008, when the world will be watching.

With the exception of the rich, most are critical and vocal about the government, wanting better governance and tighter legal controls. However, despite the concerns about inequality, there are no current threats to the party. Urban dwellers will not demand change as long as they are outnumbered by rural residents. Since the late 1990s China has privatised urban housing, and the property owning middle class has enjoyed the consumption surge and hence a new found desire to protect property. For the urbanites, there is no point in trying to overthrow the party as that could cause chaos and threaten wealth, whereas rural residents are dispersed and would find it difficult to unite.

Without a sharp downturn in the global economy or big crisis internally, China will grow strongly for the next five years. This should enabled the government to sort out the banking system, deal with land ownership, and fix healthcare and education and create a social security system. This is a requisite if China is to survive the era to follow, when China's working population will begin to decline and the population will start to age.

Other risks

Clearly I could go on further detailing risks about North Korea and bird flu, but these risks are less quantifiable, and it is time to establish where the opportunities lie for investing in China.

Confucius says: Invest wisely, or perhaps not at all (actually he didn't say that)

So what is a valid investment strategy in China? Beyond the specific industries it seems essential to us that management ownership in the company is vital, as this is one of the few defences against corruption. It would be wise to avoid exporters who will be damaged by a slow down in the global economy, and by a rising currency. It would also be wise to avoid stocks sensitive to interest rates. Beyond that, it is wise to research the beneficiaries of the growth and consumption boom.

With the growing economy, suppliers of infrastructure, such as power companies, natural resources, property developers, rail, ports and shipping, telecommunications are all likely to prosper. In addition, the consumer industries, such as cars, dairy, food producers, food distributors, clothes manufacturers, household goods, brewers, consumer banks, and travel agencies will benefit. In terms of food, farm input suppliers are a clear beneficiary of the massive demand and the agricultural revolution, so fertilisers and animal feeds stand to do well. Lastly, there are companies set to benefit from the increase in healthcare and education provision. There are no GPs in China, and you still have to prove you can pay before they treat you at the hospital, something to bear in mind when crossing the road! So private healthcare and dental care is a clear growth area. However, we are more likely to back investment managers searching the smaller company arena aggressively to find value where management and pricing inefficiencies lie. In addition, there is clearly massive potential for M&A in this inefficient, but rapidly evolving economy.

Lucky red

For traders, there are fast profits to be made in many of the privatisations of state owned enterprises (SOEs). Telecommunications, Insurance and reinsurance, now the banks have been privatised, and the Postal service and Rail are expected to be next. The demand for the banks shares has been beyond sanity, as evidenced by the initial public offering (IPO) for Industrial and Commercial Bank of China (ICBC). In the world's largest



flotation, ICBC raised US\$22bn from its dual listing in Hong Kong and Shanghai, although the domestic tranche attracted US\$90bn, and the shares rose 15% rise on the first day of trading, showing just how much excess liquidity there is. Incredibly, the IPO valued ICBC at \$131bn, \$41bn less than the government support it received over the last 8 years. The valuation suggests the bank may be destroying \$5bn of capital per year. Those sounds like some dim sums to me. However, there is a clear strategy for any of those investors lucky enough to have enough qualified foreign investor quota to make rapid profits as these stocks rapidly rise to insane valuations. This is clearly bubble territory.

After all the optimism I had experienced, it was refreshing to interview a fund manager who takes a more measured approach. The manager builds into his investment process an expectation that a third of his investment choices are likely to be mistakes, a third are likely to be 'sleepers', and a third are expected to be winners. The psychology of investing is always important, and we are sceptical of any manager that does not build an element of behavioural finance into their process. The same manager has an approach which attempts to avoid the hype by searching out smaller, less well known companies trading at lower valuations. The fund manager would then talk to the company's customers and distributors to better understand the company's growth prospects and industry dynamics. This qualitative aspect is vital in less developed markets, where legal research is often more important than number crunching. The team will travel to visit these less researched companies, and have been known to revisit the company a few hours later to check that the operation is still in place! The manager is affectionately known as China's answer to Warren Buffet, and because of all of the above the fund will warrant further investigation by us over the coming year.

A sting in the tail?

The market is rocketing and is likely to see significant volatility. Hence we consider that the wise way to approach investment in China is by focusing on a lower volatility hedge fund or a niche area, or through private equity. Since legal issues provide an even greater threat to direct investment or private equity, that leads us to focus on hedge funds. However, hedging strategies are not easy when everything is going up. Also, only the 400 stocks listed in Hong Kong have equivalent derivatives established, the domestic A shares are not structured for hedge strategies yet. In addition, whilst a properly constructed hedge fund may fare well in the event of a market correction, investors may still face the problem of extracting assets from China.

On the flight back to Hong Kong, I had the pleasure of sitting next to two American businessmen, who had just been ejected from Shanghai for lack of visas. They were coming to Shanghai to buy ceramics (crockery and lampshade bases) to import and sell for extraordinary mark ups to desperate housewives. Whilst they clearly hadn't done their homework in terms of visa requirements, it struck me that their business model was extremely simple, niche and robust. This should also be a guide for investment in China, focus on what you can be certain of and don't regard China as a whole. Our approach so far has been to focus on derived demand – the resources and commodities (metals and food) that China continues to consume so rapidly, and the markets that benefit from China's growth, such as Japan and the rest of Asia.

2007, the year of the pig

It is likely that within the next 3 years, as the financial and legal systems mature, we will reach a point of confidence where a more direct approach is warranted. However at present, for the risks stated above, we intend to avoid direct investment in China and therefore avoid any potential squealing in the year of the pig. I wonder what Confucius would say about that.



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