

Investing in China: Finding Opportunity With a Long-Term View

Go beyond the short-term volatility and do your homework to find the gems that will outlast the headlines

Chinese stocks are having a rocky start this year, with the overhang of the U.S.-China trade war and signs of slowing domestic and global growth. Yet there are very attractive valuations, particularly in the A-share market, in the world's second-largest economy, which is increasingly relying on domestic consumer-driven activity and positive market developments. Several reasons support buying opportunities in the Chinese stock market for institutional investors, as this P&I roundtable of experts explains. The panel includes Tom Harvey, senior equity specialist at Aberdeen Standard Investments; Brian Beitner, portfolio manager at Chautauqua Capital Management, a division of Baird; and Richard Gao, portfolio manager and research principal, China, at Matthews Asia. While spotlighting opportunities, the panel also cautioned that investing in China requires a close watch on a sentiment-driven market, government policy and the ongoing trade situation.

Pensions & Investments: How should institutional investors be looking at the volatile U.S.-China trade relationship that continues to make headline news?

BRIAN BEITNER: For China, trade is an issue, but it is not the only issue. The Chinese government is arguably in a better position to weather a trade war than the United States for a number of reasons. Investors should be mindful that trade tensions are certainly going to have an impact on Chinese economic growth and U.S. economic growth. In both cases, in anticipation of higher prices due to tariffs, exporters and importers loaded activity on the front end in 2018. By comparison, in 2019, there should be less trade activity back and forth between the U.S. and China, even absent of implementation of higher tariffs. Some have argued that inventory buildup in the United States has resulted in a 1.5% to 2% increase to GDP growth in 2018. So the absence of that is likely to be pretty significant, and the impact for China, even bigger.

RICHARD GAO: The U.S.-China trade tension has been a big overhang on the stock market in both the U.S. and China, and we have been closely watching it. We are, at this stage, optimistic about a final deal being reached between the U.S. and China on this trade dispute. The issue has been dragging for quite a long period of time. At this

point, both sides realize the severe impact on their economies. Not only does China feel the pain, but now U.S. companies are also starting to feel the pain. For example, you saw companies like Apple, Starbucks and Tiffany's all report weak [earnings] numbers because of the slowdown in the Chinese market. So both sides feel the pressure to reach a deal, and we believe that both sides have realized that cooperation and concession, rather than confrontation, will leave the two countries better off.

P&I: Is China's shift toward a services-driven economy and away from an export-driven economy having a mitigating impact on negative fallout from the trade war?

TOM HARVEY: A lot of people would view the shift that China is going through, from being export-driven toward more of a service economy, as probably very good for long-term growth. From a fundamental standpoint of some of these companies and how they are performing, there is an engine there for growth. It is the world's second-largest economy, with trade partners around the world. That being said, it is hard to escape some of the overhang, whether you are talking about how companies might actually perform or how their share prices perform; it has been difficult to escape the headline news with regards to this trade war, and obviously some actions in the form

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of tariffs coming down. We've seen that this services-driven shift has not done a whole lot in the short term to shield the volatility from the stock market.

GAO: It is very important to keep in mind that China is no longer a country that relies as heavily on exports as it did a decade ago. China's exports to the U.S. accounted for around 9% of its total GDP about a decade ago, but in 2017, exports to the U.S. only accounted for about 2% of GDP. At the same time, China's domestic-consumption in the services economy is playing a more and more important role. The contribution of domestic consumption to GDP growth in China has moved from less than 50% in 2013 to around 80% in the first nine months of last year. So China is really becoming a more domestic-consumption and service-oriented economy.

BEITNER: In terms of historical context, the notion of "harmonious society" is an ancient Chinese concept, but it became a policy priority all the way back in 2006. One of its central tenants was to shift away from an industrial export economy to a more domestic and consumption-oriented economy, and China has made very good progress, as Richard pointed out, toward those goals. But they do still have a ways to go.

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— **TOM HARVEY, Aberdeen Standard Investments**

P&I: What impact has the Chinese government's response to the trade war had on Chinese companies?

BEITNER: When Xi Jinping and Donald Trump met in Buenos Aires in early December, the Chinese achieved a fairly significant advantage in getting the implementation of tariffs delayed by 90 days. It gave the Chinese government and Chinese companies more time to adjust to a potential tariff environment. Chinese manufacturing companies have been moving operations out

of China to bypass the tariffs. Shenzhou International, a supplier to Nike, Puma, Adidas and Uniqlo, for example, is going to make its products that come to the United States in Vietnam and Cambodia, while products sold in China and other places in Asia and Europe will continue to be made in China. So Chinese companies have been able to bypass and protect themselves from a tariff issue, where a soybean farmer in the United States is not going to have that same ability.

GAO: Also, the Chinese government has been taking some specific measures, such as cutting taxes and increasing lending to small- and mid-size companies to help them deal with the tariff situation. These measures have been announced in the past several months. We have not seen the specific results yet, but early this year we expect to see some positive impact on those SMEs [small and medium enterprises] in China.

P&I: How big of an issue is the high level of Chinese corporate debt for institutional investors?

BEITNER: When discussing debt in China, one has to consider the composition of that debt. Relative to the U.S., Chinese household debt as a percentage of



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gross domestic product is a modest two-thirds of U.S. household debt. Government debt is also a smaller percentage of GDP: It is less than half that of U.S. government debt to GDP. But Chinese corporate debt as a percentage of GDP is four times that of the United States. So China's debt problem is largely centered on corporate debt and, more specifically, state-owned enterprise debt. In China's case, debt has grown 54% faster than GDP. That is a significant problem. The Chinese government is taking initiatives to address this problem by doing debt-for-equity swaps and trying to merge zombie SOE companies with healthier companies. But it will take a long time to correct the problem. China is not going to address the problem aggressively, as that would have sharp negative repercussions for the Chinese economy. But ignoring the problem will only mean that it gets worse.

GAO: I totally agree with Brian on the fact that the majority of the corporate debt in China comes from the SOEs. On the other hand, privately owned companies have been deleveraging over time in China. That is a very positive development for the Chinese economy because SMEs now account for the majority of job creation and investment growth in China. The healthy development of Chinese SMEs should provide a long-term, sustainable support for the economy.

P&I: How should institutional investors view the recent decline in the Chinese stock market and what is your longer-term view on the country's stocks and stock sectors?

HARVEY: Despite the decline in returns last year, particularly after 2017, when returns were so outsized, institutional investors should still be quite pleased if they hold a long-term view on Chinese stocks. As we look at where corporate growth is headed, even with the overhang of the trade-war resolution, we see very healthy corporates on a case-by-case basis. Companies that are exposed to that domestic-services story within China, which we talked about as becoming a bigger portion of where China's GDP comes from, have suffered nonetheless, as their share prices have fallen. Fundamentally, though, they are doing quite well. Investors should see this as an opportunity where earnings

growth looks quite healthy, even though valuations have come down pretty far depending on the sector.

The Chinese Internet sector captures people's imaginations and captures a lot of the assets, and that is really due to the size of the sector and these companies. These holdings likely appear in broader portfolios that may not be a dedicated China allocation. But in the consumer space, it has been difficult for some investors to figure out how they get the quality of consumer exposure that they are looking for. As MSCI and FTSE are now starting to include A-shares in the indexes, it is opening up the opportunity set to investors.

BEITNER: The emerging markets were weak in 2018, and China underperformed the emerging markets, so we are now at a point where valuations are pretty compelling. China is the second-fastest-growing large economy in the world right now. So as pundits talk about slowing growth in China, be mindful that it is coming down from a high level and it remains, in absolute terms, among the fastest-growing economies in the world.

We think China is transitioning its economy meaningfully with a lot of initiatives that will enable it to materially further improve living standards. It is undergoing a bit of right-sizing, where the government is tightening regulations in a number of different industries that push marginal performers out and create a bigger opportunity for leaders. China is spending for ultra-high-voltage grids, electric vehicles, renewable energy and high-speed rail. It is improving production efficiency and facilitating more urbanization. We continue to see terrific opportunities in e-commerce, travel, education and health. Leading companies are still fast growing and, at this juncture, they are trading at reasonable valuations.

GAO: I agree that even though the domestic Chinese stock market has declined quite a lot, we see it as more

of an opportunity going forward. I have covered the Chinese A-share market [domestic renminbi-denominated stocks] for more than 15 years, and this is really the first time that I have ever seen Chinese A-share company valuations come down to the current level. It is currently at close to 10 times PE, which is really very rare. The A-share market was usually trading at 30 to 40 times earnings, and at much higher valuations versus overseas listed Chinese companies. So we are quite excited about finding good companies to invest at these (A-share) valuations.

Also, as MSCI recently announced the inclusion of A-shares in its indexes, that has opened up this very new, large investment universe for foreign investors, and it is too big to be ignored. There are more than 3,000 A-share listed companies, many in the consumption and service-oriented areas. These include consumer discretionary, consumer staples, health care, education, travel and leisure. Many solid companies in these sectors that are listed only on the A-share market have become very attractive.

It all comes down to stock picking in the A-share mar-

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kets because, as we all know, the market has been very volatile. It is still quite a retail-, rumor-driven market, and poor corporate governance could still be a big issue. So we need to be focused on on-the-ground due diligence and research efforts to find companies run by solid management, with very strong business models that are trading at relatively cheap valuations.

P&I: Given the focus on the major Chinese e-commerce names, what will it take for institutional investors to make the leap toward the broader investing opportunity in Chinese stocks?

HARVEY: For investors in emerging markets, if somebody is close to the benchmark, 30% or so of the allocation might be invested in China, with big portion invested in Chinese Internet names. To a degree, it is probably a learning experience for institutional inves-

tors to broaden their exposure. A lot of what Richard just talked about, this whole suite of 3,000-plus companies in China's A-share market that people are largely unfamiliar with, it comes back to thinking about, where is GDP coming from on a global basis? As MSCI and FTSE are starting to add A-share exposure, investors may now be seeing this sector as an opportunity set that they have not been able to access in the past, and they are either learning about it or just starting to invest.

BEITNER: Even aside from A-shares, the role of China relative to the benchmarks is quite distorted. If you look at EM on a cap-weighted basis, China, including A-shares, equals 30% of the MSCI Emerging Markets index. However, at the end of last year, China only represented 3.6% of the MSCI All Country World index benchmark, which includes the whole world, while the U.S. represented 54.4%. On a GDP basis, China

represented 16% of global GDP, whereas the U.S. represented 24%. So the marked difference in their benchmark weights is notable relative to the more comparable sizes of these two very large economies. Investors need to decide if they want to anchor to a benchmark or to economic activity. We think it is better to anchor to economic activity, where wealth is being created based on that economic activity.

GAO: Given these benchmark distortions, institutional investors are rethinking their allocations to China. We know institutional investors tend to follow the MSCI weighting to allocate their assets. When it comes to China, I would encourage people to take a more active investment approach. MSCI's criteria to include stocks in the index can be more to do with liquidity and market cap, but we are focused on finding companies that are solid in their management, business model



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and valuation. We tend to focus on smaller-cap companies, companies in the domestic-consumption and service-oriented industries where we see future growth opportunities. These can be private, non-SOE companies that can be quite different than MSCI's inclusion of China's stocks.

P&I: How can institutional investors best access the large universe of publicly traded Chinese companies?

GAO: When you look at the available investment vehicles to invest in China, most are tied to the benchmark weight. So for example, a lot of China-specific investment vehicles have significant exposure to companies like Baidu, Alibaba and Tencent (that trade on U.S. exchanges as ADRs). That can account for a significant weighting in those investment vehicles. While we do have exposure to those types of companies, our effort has been more to find the future growth opportunities in China. These are the smaller companies I mentioned earlier that have smaller weightings in the MSCI index but, in our opinion, they provide more long-term growth.

HARVEY: One way that institutional investors have gotten access is probably through a manager investing on a broader scale, whether that is a dedicated EM mandate or an Asia Pacific mandate. Within there, you have that heavy allocation to the ecommerce side of things. Depending on how you are investing, you may have a higher proportion of some of the SOEs. We would agree with both the other managers here that stock picking is important and how institutional investors get access to the China A-share market is important. The greater ease at which clients in the U.S. or in other parts of the world are able to access China's A-share market, thanks to the Stock Connect programs, will broaden their universe of where they are able to invest. We also continue to see positive market-related developments including some better rules or tighter restrictions around when a Chinese company can suspend its stock if they are going to restructure, announce something or issue shares.

P&I: When institutional investors are considering China, should they think about an allocation separately or as part of a broader emerging markets allocation?

BEITNER: We manage a worldwide global quality growth strategy and a non-U.S. quality growth strategy. So we think about China more broadly. But relative to other parts of the world, we are fairly optimistic about China and, as a result, we have a pretty healthy but selective exposure to China. In the global strategy, it is over 8%, and in the international strategy, it is over 18% of total assets. At the same time, we view China as risky and volatile, the country is heavily indebted, it is going through a very significant transition trying to shed excess capacity, upgrade its economy and move successfully to avoid a middle income trap. As a result, we do not look to Chinese equities for income or capital preservation, but try to be very selective and find quality growth opportunities where companies benefit from long-term trends and possess sustainable, competitive advantages.

In terms of examples, we hold a position in a leading

manufacturer of batteries and electric vehicles. We see them gaining share in a soft auto market. We also own a dominant after school education provider and the largest online travel agency.

GAO: Yes, global investors should seriously consider a dedicated allocation to China. Institutional portfolios should reflect China's economic importance as the second largest economy in the world. Unfortunately, current EM benchmarks significantly underweight the opportunity. In terms of the A-share market, we like the consumer staples, consumer discretionary, health care and technology areas. One example we invest in is a liquor company that is a leading luxury brand. This is an industry that has not been available to investors outside of the A-share market. Another example is a pharmaceutical company that is a leader in having the largest R&D expenditure and biggest pipeline of new drugs. China's health care development continues at a fast pace and pharmaceutical demand is very strong in a very competitive market.

HARVEY: We think China's A-share market offers some pretty interesting opportunities for institutional investors to build their China exposure. It really is a stock picker's type of market. If you are careful, do your homework, have boots on the ground and can go in and actually kick the tires on these companies to find the best quality and the best long-term prospects, you can find good opportunities.

P&I: What are some of the biggest risk factors on your radar screen when investing in China?

GAO: Real estate is probably the biggest risk factor in China right now. Property prices have been rising for more than a decade without any major correction, especially in the big first-tier cities in the country. Affordability has become a real challenge now. The government has tried to control real estate overheating risk by some heavy-handed interventions such as putting price caps on property selling prices, limiting bank lending toward property developers and controlling mortgage activity for buyers. We are very alert to any slowdown of the property market because property-related activities account for almost one-quarter of the country's overall economic activity.

On the market itself, the Asia market continues to be a very retail-driven market and that has led to significant volatility from one year to the next. Stock movement will still be driven not by fundamental issues, but by rumors and news-driven activity. However, we are starting to see more participation from institutional investors, mutual funds, securities companies, insurance companies and even pension funds, in the domestic Chinese A-share market. I believe that the volatility of the A-share market will gradually come down, and the more fundamental and quality listed companies will be more rewarded in the future. Ultimately, it all comes down to on-the-ground stock picking, and doing our fundamental analysis to avoid all those risk factors.

BEITNER: Debt, demographics and backsliding from free market progress are the three big long-term risks we are concerned about. The level of corporate indebtedness is self-contained as SOE banks hold most of the SOE companies' loans. Nevertheless, this situa-

tion inhibits growth for the overall economy because the banks aren't able to provide as much credit to the faster growing, small-, mid-size private enterprises. Demographics is definitely a problem as the one child policy has come home to roost. China is hoping to get rich before it gets old, but it will have 844 million people retiring from 2011 through 2050. So with this working population shrinkage problem, China will need to further automate and improve productivity or allow immigration, or it is going to have a mismatch between its capacity and its population. We are keeping a close eye on developments that signal China could backslide from the free market initiatives of long ago that have been so fundamental to its rapid industrialization and ascension. So net-net, we are optimistic about China, but there is plenty to keep us awake at night.

HARVEY: I'd add another risk that China will have to deal with, over the short- and medium-term, is inflation.

Part of it is looking at what is the actual impact of the trade negotiations between the U.S. and China? Also, what is the impact of the measures that China has put in place, good measures, but that ultimately will cost companies more in terms of cleaning up the environment and meeting different regulations, and whether and how that cost gets passed on to the consumer? We are still excited about the consumer being in pretty good health, so we are watching what happens with regards to costs being passed on as we move through 2019.

I'll end on a double-edged positive here: for investors looking at China's A-share market, one of the big misconceptions is the worry over liquidity. But investors, perhaps, just do not realize the size of this market. We see China – it flip-flops with Japan from time to time – as the third-largest stock market in the world today, and one of the best when it comes to liquidity. We see a number of positive measures designed to

protect shareholders such as rules that make it harder for companies to suspend shares, improved corporate governance with more independent directors at some Chinese companies and better dividend policies. And Richard made a good point about increased institutional ownership of these shares. We think that is the continued direction of travel in the A-share market and its continued inclusion in the indexes. ■

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