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Investing in China: Finding opportunities and managing risks

The Chinese economy is large, growing and full of opportunities for investors. But these opportunities come on the backdrop of risks like U.S.-China trade tensions, high-levels of debt and volatility. In this expert roundtable series on China, investors share their views on where to find opportunities in this massive new market. This discussion provides essential information for Canadian plan sponsors looking to invest in China.

MEET OUR EXPERT PANELLISTS

Expert Panel 1

TIFFANY HSIAO
Portfolio Manager,
Matthews Asia

ANDY ROTHMAN
Investment Strategist,
Matthews Asia

JASON R. STEFANELLI
Director, Head of Canada,
William Blair Investment
Management

VIVIAN LIN THURSTON
Partner, Portfolio Manager,
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Expert Panel 2

BRAD GIBSON
Portfolio Manager—
Asia-Pacific fixed
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JOHN LIN
Portfolio Manager—
China equities,
AllianceBernstein

CATHERINE YEUNG
Investment Director,
Asian Equities,
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Note to readers:
These roundtables took place in November 2018. The coverage of both roundtables has been combined, condensed and paraphrased for length and readability.

Where do you see the biggest opportunities when it comes to investing in China?

Expert Panel 1

Andy Rothman China is the world's best consumer story. You've got very strong retail sales growth and a very large retail base. Ten years ago, retail sales in China converted to dollars was equal to about a quarter of retail spending in the United States. Last year, it was 90 per cent. Within a few years this is going to be a larger volume of consumer spending than in the United States. And it's not based on Chinese consumers maxing out their credit cards. It's based on strong income growth. Over the last ten years, real household income in China rose 123 per cent versus 14 per cent in Canada. And while household debt is rising, most of it, I think, is very safe because it's in mortgages where people are putting at least 30 per cent cash down, so I think this is a very sustainable consumer story.

Jason Stefanelli Plan sponsors should be prepared for an environment of lower returns from equities and bonds, as well as the possibility that equity and bond returns may even see increased correlation. So, this is where diversification really comes into play. Plan sponsors in Canada, when they look at the late-cycle dynamics, feel that if central banks around the world are able to reduce monetary stimulus effectively, emerging markets and China specifically are likely to benefit from a combination of early-cycle dynamics, cheaper currencies, strong growth and relatively low valuation.

Tiffany Hsiao Asia is very early-cycle and, particularly in China, there's a strong structural story behind the shift from a manufacturing and asset-heavy-based economy to now a consumer and services-driven economy. So, in that context, we really believe it's the smaller companies that will do very well.

> "…if central banks around the world are able to reduce monetary stimulus effectively, emerging markets and China specifically are likely to benefit from a combination of early-cycle dynamics, cheaper currencies, strong growth and relatively low valuation." *Jason Stefanelli, William Blair*

Expert Panel 2

Catherine Yeung An area we are looking at is that many of the state-owned enterprises are now being encouraged to increase their quick cash flow yield as well as their dividend yield—really to reward minority shareholders. So investors, instead of just looking for growth, will start looking at the income side of the equation as well.

Brad Gibson Within the onshore fixed income market we have not yet invested in the corporate bond market and we've been focused on the rates side of the market, Chinese government bonds and policy bank bonds. Both of these act as the safe-haven, or defensive sector within the Chinese financial system. We also have done analysis of how Chinese government bonds perform within a global bond portfolio and the results are encouraging.

John Lin The Chinese A-share market is the second largest market in the world by market cap, even after the year-to-date fall. It's very big, very broad and super deep in liquidity. You've got over 3,000 companies listed there, and the richness of the market means that no matter what's happening there are always going to be good companies you can find. Hundreds of small to mid-size companies are going to be overlooked or forgotten, particularly by international investors who are not familiar with this market.

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Within China, in which sectors are you seeing the most promise and why?

Expert Panel 1

Tiffany Hsiao China needs to be self-sufficient in these three industries [semiconductors, software and biotech] because these are really at the core of the continued functioning of the new Chinese economy.

Everything is now run off the internet and what's behind the internet are these semiconductors. So semiconductors really are the new oil in China's new economy. And if China does not have self-sufficiency in this very critical resource then it could cripple its growth.

And in the area of software, because the economy has transitioned to a services economy, your people are your asset. You need a lot of software to enhance the productivity of these services industries and to properly document all the intellectual property that's been generated.

And finally, on biotech, you need indigenous innovation and scientists to create drugs that are a fit for the more prevalent disease types in China.

Jason Stefanelli What could be interesting to Canadian investors is this notion of beta diversity. There's not a lot of profound representation in the Canadian equity market in healthcare, tech and consumer discretionary, so these global sectors in China represent an opportunity where there's less representation at home.

Expert Panel 2

John Lin We think things like materials in the upstream industrial part of the economy are still very interesting today.

And of course the consumer space. I don't mean just looking at companies listed in Hong Kong or at American depository receipts (ADRs), because, quite frankly, everybody knows those Alibabas of the world. But if you look beyond the surface there are a rich set of medium-sized enterprises listed in the A-share market, from chicken farming companies to leasing companies that deal with aircrafts, that are going to be enjoying this continued growth of Chinese middle-class consumers going forward.

Catherine Yeung The consumption story really is key from our perspective. So, while the demand side is really visible, what we've been really focusing on over the past couple of years is the supply side. We think that there's going to be a change in mindset when it comes to investing in China, both from a domestic mainland investor's point of view as well as a foreign investor's point of view. By that I mean in years to come, people aren't going to look at China just for Alibaba or that consumer theme, but instead look at the total return aspect.

Specifically in the consumer space, and tech to a degree, in the current environment of market falls and a lot of stocks being sold off indiscriminately, we've been looking and searching for fallen angels—those names whose earnings visibility is still there, but whose share prices have dramatically decreased.

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>
> *Tiffany Hsiao, Matthews Asia*

Turning to equities, MSCI has added China A-shares to its Emerging Markets Index. What opportunities and what risks does this pose for investors?

Expert Panel 1

Vivian Lin Thurston This is the first time that such a large asset class with very high liquidity has become widely available to global investors. From a plan sponsor and investor perspective, you can't ignore this market because it's so big. It is also a highly inefficient market with a low correlation with most other equity markets in the world. This presents a large opportunity for active management as well as offers diversification benefit for global investors. Last but not least, the China A-share ▶

Expert Panel 2

Brad Gibson The volatility of the markets is quite high in China and that does need to be addressed. Given this sort of command and control economy, investors are now very accustomed to investing by what policy makers are doing. We've seen this over the last ten years, as market participants have lurched from one market to another depending on what policy makers are doing. So, when the equity market was falling in 2015, they boosted the corporate bond market so all of ▶

market provides unique and attractive exposure to the structurally growing sectors of China such as consumer, healthcare and technology, with both breadth and depth.

From a risk perspective, the China A-share market has a few things I think the global investment community should be aware of. First, it has a trading suspension going on. During the recent crash in 2015 the trading suspension was as high as 30 per cent of the whole market. Now we have about 2.3 per cent of total China A-share companies suspended, so the ratio has come down tremendously.

The second risk is that it's a very heavily retail-driven market. So you get very high volatility from time to time, but this also contributes to inefficiency and very low correlation versus most other equity markets in the world.

Third, there's a pledge risk that is very prevalent. But the government has been actively working with all the brokerage companies and banks to ensure that there aren't a lot of blowups.

And at a fundamental level, the biggest risk I think is political—it's the U.S.-China relations—and we don't know how that will play out in the end.

a sudden money left the equity market to the corporate bond market and then when the corporate bond market was looking a bit too hot they clamped down on that and money left and went into the property market.

I think this very policy-driven behaviour of onshore investors over time will reduce and I think initiatives to encourage a long-term pension-based savings culture will go some way to alleviating that short term, domestic policy-led investment style. For an offshore investor looking into China, it is difficult to get their heads around because it's a very reactive style of investment.

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Focusing on China's small cap markets—can you please give an overview of what's been happening in this space and where you see it going?

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Expert Panel 1

Tiffany Hsiao Chinese small caps have been among the least leveraged small caps around the world, yet they have generated the highest return on assets. China is a very special case where the smaller companies historically have had absolutely no channels to acquire capital as the banks didn't lend to private companies and there was a lack of capital stock in the private sector. These businesses grew up in an environment where they needed to pick structurally growing sectors and be very smart about their working capital management. They've retained that DNA to this day by operating in a very capital efficient manner. Given the worry about debt in China, I think you're much better insulated by being overweight in smaller companies.

Expert Panel 2

John Lin An interesting phenomenon that we've noticed investing in both sides of China is that in the A-share space, small caps trade at a premium. Anywhere else in the world in major equity markets it's the reverse, small caps tend to be cheaper. So why doesn't that work in the A-share space? Retail investors are almost 90 per cent of the market and many of the institutional managers, or the portfolio managers, are incentivized on such a short-term basis. Investors are in it to make a quick buck—so they're focusing on small-cap stocks because quite frankly the large-cap stocks don't move that quickly. There's actually a very interesting set up for investors who do their homework to perform in the A-share market because it's so retail dominated, so if you just understand and dig a little deeper beneath the surface, there's a lot of performance to be had if you just have a little bit of stomach to endure the volatility.

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>
> *John Lin, AllianceBernstein*

There is a looming trade war between the U.S. and China; how are you seeing this play out in the markets? And where do you think discussions on trade between the U.S. and China are heading?

Expert Panel 1

Andy Rothman The big debate in the U.S. right now is whether or not engagement between the two largest economies in the world has been productive for the United States. There are some people who are arguing that over the last few decades engagement between the two countries hasn't worked. I think that's a terribly misguided assessment. We've brought China into the global infrastructure and they've been playing by our rules in our systems and it's worked really well for us. Since China joined the World Trade Organization, U.S. exports to China are up almost 600 per cent whereas U.S. exports to the rest of the world are up 100 per cent. It's become the most important export market for U.S. agriculture. It's also produced a lot of great results in China.

So the reason I'm going through this is—the evidence is clear that engagement has worked, and is the best way to achieve more progress on the remaining challenges in U.S.-China relations.

Note: After the meeting at the G20 in Argentina between the American and Chinese presidents, Rothman added to this response in a statement saying:

I'm optimistic that the positive language from both Trump and Xi, after their G20 dinner, suggests that they agree on engagement, and I think the prospects for real progress on substantive issues with China are now better than at any point in the Trump administration.

Expert Panel 2

Catherine Yeung There are about five areas that need to be tackled between the U.S. and China: low-hurdle issues as well as high-hurdle issues. Low-hurdle from our perspective would be the trade imbalance, intellectual property rights, the opening of markets and higher hurdles would be the Made in China 2025 strategy, and state-owned enterprises subsidies, particularly evaluating the subsidies state-owned enterprises currently receive and benefit from. We would argue that, in terms of valuations, the risk has been priced into the Chinese markets.

John Lin Thus far, China has refrained from engaging in the sense they haven't stopped Starbucks from selling coffee in Shanghai and, if we were to really get into a trade conflict, those businesses would be hurt too. I'm not sure the U.S. market is properly pricing in the risk.

Catherine Yeung I absolutely agree. We only have to look back at how the Chinese government was a little bit upset with the South Korean government and as a result, you didn't see Chinese tourists going into Korea and Korean imports were banned. So, from a trade perspective I completely agree. If we do see the worst-case scenario playing out, it will be the global consumer that's impacted the most and we run the risk of inflation.

> **"If we do see the worst-case scenario playing out, it will be the global consumer that's impacted the most and we run the risk of inflation."** *Catherine Yeung, Fidelity*

Obviously, there are high levels of debt in China. Do you think there's a debt problem, and can you provide an overview of the situation?

Expert Panel 1

Andy Rothman There is a significant debt issue in China. But I don't think it represents a systemic risk because the debt problem in China is the result of the Chinese government instructing Chinese government-controlled banks to lend money to Chinese government-controlled companies to build government-directed ▶

Expert Panel 2

Brad Gibson China embarked on a deleveraging cycle so that level of debt to GDP has at least stabilized. But I think it would be wrong to suggest that China has managed to delever. It's hard to ignore debt buildup, which has supported growth levels north of six per cent and we do think that does have ▶

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public infrastructure. So, there is no private participation, no equivalent of a Bear Stearns or a Lehman Brothers. What this means is while the problem is significant, since it is state companies that owe money to state banks, the government really is able to control how this is resolved and over what time frame. And that's why I think the systemic risk is very low.

Vivian Lin Thurston The downside risk is probably more manageable than Western countries think, given that there are probably limited systemic risks. The government is fully aware its debt level is too high and not sustainable. It has done something recently, which is deleveraging, and that was partially the reason that we have seen the slow-down of China's economy in recent times.

an impact on policy effectiveness and the desire of businesses to take on more debt. I think it's gotten to a stage now where attempts to reduce the level of debt are very difficult and that is being exacerbated because of some external pressures, which have forced them to stop this deleveraging process and focus more on the shorter-term, propping up stability.

Beyond China's borders, do you see China's growth leading to other opportunities for investment in Emerging Asia. If so, how? If not, why not?

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Expert Panel 1

Vivian Lin Thurston I do think if you look at history, China has been a very important driver of Emerging Asia's overall economic growth, both from the supply chain side and from the demand side. In the near term, the U.S.-China trade war would potentially benefit some of the countries given that there could be potential multi-national companies moving their supply chain away from China to other countries or regions and so they could be a beneficiary of that relationship.

Tiffany Hsiao The trust between the U.S. and China, I think there is some permanent impairment in this process, so we're definitely seeing new supply chains forming in Southeast Asia as a backup and perhaps the more sustainable longer-term solution to these conflicts that are unpredictable in nature. So, it will benefit some of these Southeast Asian countries that can easily follow China's early playbook.

Expert Panel 2

John Lin Slightly shorter-term on just a simple 'China's loss is whose gain?', all you need to do is look at the best performing stocks in Taiwan year-to-date and many are in textile and low-end tech hardware companies. So on the very initial reaction, and certainly as investors' expectations go, some of the order will immediately be shifted to places where you don't have tariffs and you have a good amount of substitute ability.

Brad Gibson In terms of bonds and currency markets, I'll back up to the long term. Asia as a region is growing at around six per cent. That type of growth is the envy of any other part of the world. There may be other pockets of growth in Latin America, for example, but there's a lot more volatility with those markets. So, thinking about the long-term investment implications, it does feel like Asia is under-represented in equity or bond investments at current allocations. There may be some reshuffling of activity because of trade tensions, but let's not forget the bigger picture that Asia as an investment destination is still underrepresented and growth is still going to support more investment over time.

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> *Vivian Lin Thurston, William Blair*

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