



Is China too risky?

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Investing in China must be the most controversial topic in the investment world right now with extreme views coming from both bulls and bears. The bears will claim victory as the MSCI China has underperformed Asia by 32 per cent in the past two years. But the bulls will argue that this underperformance is really driven by the large capitalisation stocks - the MSCI China Small Cap Index has outperformed Asia by an astonishing 66 per cent. We believe this reflects the need for an "active stock selection" approach to investment.

The current investment climate in China could not be more confusing. On the one hand, there are signs of recovery in the West that bode well for Chinese exports and Chinese retail and economic data point to very strong domestic consumption. On the other hand, inflation bordering on three-year highs with significant tightening measures imposed by the Chinese government fan fears of an economic hard-landing. These broad-based measures range from raising interest rates and bank reserve requirements, shutting down unproductive mines and cement plants to imposing stricter measures to tighten mortgage lending. All these factors add to the quandary for investors.

In our view, successful investing in China requires a profound knowledge of conditions on the ground. However, there is no doubt the Chinese economy is on a firm footing, and with the government well in control of inflation, there should be little risk of overheating.

For the past decade, China has been on an indiscriminate growth path - expansion at any price. Going forward, we cannot expect the same explosive growth. Development will be at a more moderate pace, but the quality of growth will get a whole lot better. Unlike in the past, the new growth push being planned by the government will focus on issues such as extreme neglect of the environment, overly loose credit and government intervention that is more "cut down to size".

Investing always comes with some form of risk, regardless of whether it is in developed economies, such as the United States, or emerging powerhouses like China. However, risks can be mitigated by a thorough understanding of the dynamics of what is going on in China.

Avoiding the traps

The biggest opportunities in China are based on an understanding of the structural nature of the economy and not passive index investing. This is especially the case when investing with large capitalisation companies in China. Many investors are attracted by the cheap valuation of these companies and the perception that they represent growth in the Chinese economy, but there is an underlying risk - most of the large capitalisation companies in China are monopolies or semi-monopolies in their field.

This stems from a command economy in the communist era where the state dictates everything. However, to promote innovation and build efficiency, the Chinese government is likely to attempt to break up monopolies by encouraging competition, through favourable policies between private and state-owned enterprises. Although the economy will continue to grow and the pie will get bigger, these state-owned enterprises are a value trap because their growth will be more tepid than overall growth of the industry.

The other trap that investors in China typically fall into is allowing themselves to get carried away by awe and wonder with the gargantuan proportions of Chinese consumption data. Some oft-quoted examples include: China has the largest beer market in the world; is the biggest producer of steel plates; and the biggest consumer of resources. Yet, in per capita terms, China is always ranked relatively low to the rest of world. Very often the lure of prospective profit when China reaches its full growth potential is irresistible. The

problem, however, is that this is a fallacy and a frequently misleading way to look at China. The important point is this - there has never been a demand issue in China. Generally, demand in China has been growing at a steady pace. For example, except for a spurt in demand due to favourable tax incentives introduced in 2009/10, car sales in China have been steadily growing at 15-18 per cent per annum for the last eight years. However, attention needs to be paid to supply factors that affect the extent of capacity expansion in the industry. Typically, China goes through a period of under-investment, and then demand catches up with supply, leading to pricing power and super-normal profits for companies that manage to survive through the lean years. Investors get excited and start throwing capital at the companies. The company's management becomes over-exuberant and projects growth that is two to three times the normal demand growth to justify the capital required to fund capacity expansion.

The whole industry then goes into an oversupply situation and margin squeeze and price wars ensue as companies realise demand is still growing at the same pace as before - and not the supernormal growth they were projecting. They then go into capital restraint and expansion stops until demand catches up with supply again, three to four years later. This is the typical boom-bust cycle that China often experiences. By being on the ground and carefully analysing signs, investors can avoid the risk of being caught in a "bust" situation.

The inflation obsession

The world's current obsession with rising inflation in China has been taken to extremes. The Chinese government has been proactively addressing inflation since early 2010 with hikes in bank reserve requirement ratios, interest rate tightening and credit rationing.

The Chinese government, understanding the risk of social upheavals if prices are not restrained, has an even stronger agenda to bring inflation under control with all the necessary tools at its disposal. Furthermore, due to the dominance of the state-owned nature of the economy, the government is well-positioned to be able to bring this issue under control. Narrowly focusing on the current inflation picture will mean that investors neglect other parts of a much diversified economy and miss out on several opportunities.

The Chinese economy and opportunities in the capital markets are very different to ten years ago. Historically, China's economy is highly dependent on its Western counterparts and is frequently termed "the factory of the world". However, the current structure and dynamics of the Chinese economy is vastly different and the capital markets offer far better opportunities than before.

Focusing too intensely on current macroeconomic issues such as inflation can distract attention from the big picture structural changes that are happening in the economy. The Chinese economy can weather this cyclical speed bump caused by inflation and become stronger and bigger than it stands today.

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