

The China Conundrum

By Dan Richards

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Few issues divide investors today more than the investment merits of China, despite that country's tremendous potential.

China's strong economic performance through the global financial crisis has reinforced this divide. Indeed, China's growth helped pull the developing world from the brink of crisis.



I see this first hand – many of the MBA students from China in my class at the University of Toronto are extraordinarily impressive and will certainly make strong contributions when they return to their homeland.

That said, skeptics question the payoff to investors from China's unquestionable growth.

So, let's consider three questions: What's the basis for getting excited about China? Are there offsetting reasons for caution?

And finally, what's the actual experience been for investors?

Causes for optimism

Commodity bull Jim Rogers is a noted China fan, as is Levi Folk, emerging market economist with the Excel Group of Funds, a fund company specializing in emerging markets.

Folk cites a number of reasons for optimism:

- China's continued prospects for growth in gross domestic product are three to four times what we'll see in developed countries.



- The sheer law of large numbers makes it an unstoppable force – with a population of 1.3 billion, China has 177 cities with over 1 million inhabitants.
- In the West, we often forget that China has been the world's largest economy for most of human history – it was only with the Industrial Revolution in the early 1800s that it was supplanted from the top spot. Some Chinese see passing Japan as the world's second biggest economy as the natural order of things, ultimately leading to its preordained role as the globe's number one economy.
- Rising incomes are leading to a burgeoning middle class. The threshold for a middle class is the point at which people can afford to spend on discretionary items beyond food and shelter. By that measure, the McKinsey Global Institute estimates that one third of Chinese are already in that category; this will grow to 70% by 2020. (Note that the threshold for being a member of China's middle class is annual income of \$3,000.)
- Rising incomes will inevitably lead to growth in spending. McKinsey estimates that consumer spending will multiply five times by 2020, putting the Chinese consumer market into the third spot globally. Even today, 650 million Chinese own mobile phones, a number growing by 10 million a month. And in absolute terms, last year the Chinese surpassed the United States for the largest number of cars purchased.
- Another reason for optimism is that Chinese business is starting to compete on the global stage – and not just as a low-cost manufacturer. A Business Week column last summer by the chief executive officer of Thomson Reuters pointed out that historically patents didn't exist in China. It didn't adopt patent laws until 1985. China now issues 30,000 patents annually, behind only the U.S. and Japan – and is projected to be in first place by 2012.

Reasons for caution

China skeptics don't dispute these facts, but point to a number of reasons for caution.

First is the huge gulf between city dwellers and the 70% of Chinese people who still live in rural areas. To this point, the vast bulk of benefits from economic growth has accrued to those in cities, creating significant tensions among those left behind.



Questions persist about whether an authoritarian political regime can put the cap on demands for freedom among its increasingly educated youth – and whether conflicts will arise as a result. The recent conflagration with Google is only one small example of this.

Then there's the tenuous rule of law. While not at the level of countries like Russia, there is ample evidence that rules are stacked against foreign investors.

Finally, China has been unable to rationalize inefficient operations, as provinces concerned about unrest from unemployment have balked at central directives.

For example, the country has thousands of small, inefficient steel mills – because local authorities resist the necessary consolidation for fear of losing jobs. Similarly, the focus on maintaining employment by China's provinces means they resist scaling back lending by banks to local businesses, even if they're losing money.

Another cause for concern is extremely low profitability by Chinese companies. Last year, I attended a talk on “The China profit paradox,” by Felix Oberholzer-Gee, a Harvard Business School professor who runs programs for Chinese managers. His research shows rapidly growing sales often lead to very low levels of profit by Chinese companies, well below their cost of capital.

The investor experience

Given those legitimate causes for caution, the preponderance of evidence tilts towards a positive outlook for economic growth.

Of course, economic growth doesn't necessarily mean that investors will be rewarded – this issue is especially germane in light of recent comments by short-seller Jim Chanos, who sees China's valuations at bubble-like levels.

So what's the actual investor experience in China been? The global standard for tracking market performance is the MSCI Index, which has data for China going back 17 years, to the beginning of 1993.

According to MSCI data, if you'd invested \$100 U.S. in World Stock Markets on Jan. 1, 1993, at the end of December you would have had \$334.

That same \$100 invested in a cross section of emerging markets would be worth \$469, reflecting the rockier ride investors had along the way.



If you'd taken that \$100 and put it into India, in August you would have had \$615; note that almost all of India's growth happened in the last seven years, with the 10 years before that being a wash.

In Brazil, that \$100 investment would be worth a whopping \$2,698, with the bulk of that growth coming from a nine-fold increase in the same seven years as India's run-up, since the beginning of 2003.

And \$100 invested in China almost 17 years ago (drum roll please) ... at the end of December was worth \$95, up from \$58 at the end of 2008.

At first I thought I'd made a mistake, so I double-checked the data. I showed this to a number of industry veterans – none of whom thought this was possible, but verified the numbers nonetheless, arriving at the same conclusion.

Making things worse, not only has China dramatically underperformed, but it's done so with incredible volatility.

One China expert told me that this might be due to the fact that Chinese public companies available in 1993 were inefficient state-owned enterprises that suffered in the intervening transformation of China's economy.

And that might well be the case.

Even so, this is a very big warning sign for anyone contemplating putting a significant part of their portfolio in China.

The prospects for growth in China are inarguable – what's less clear is how much of that growth is already built into the price of Chinese stocks and whether outside investors will benefit from that growth in the same way as that country's citizenry.

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