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Stewart Investors
St Andrews Partners

Our thoughts on China

China exposure

We currently have no direct Hong Kong/China exposure. We do, however, have economic exposure to China via companies not listed in Hong Kong/China, e.g. Taiwanese companies and multinationals, and this would account for a weighting of approximately 5 – 10% in our emerging markets portfolios, depending upon calculation method used. We have owned many Chinese/Hong Kong companies in the past, even owning some prior to China being included in the MSCI many years ago. We would love to own Chinese companies within our funds, and whilst there are several companies we believe are more than good enough, none we believe are good enough while also being sensibly valued. There are, however, many companies and sectors where we would find it difficult to invest our clients' capital.

China specific risks

China shares many of the same risks as any emerging market where there is a variable rule of law. China is simply a larger economy and, therefore, a much bigger index constituent. There are, however, some particular risks which are seldom seen elsewhere in emerging markets but which we see and avoid in China. We have never enjoyed investing in companies that are close to the commanding heights of any economy, and in an autocratic regime such as China, the dominance of the State often puts national interests first, ahead of that of minority shareholders.

As a result, we avoid industries that are not open to foreigners, and where access is only through a VIE (Variable Interest Entity) structure. We have never owned any company containing a VIE structure. These are structures designed to avoid rules preventing foreign ownership of certain industries, are unproven in law, and require trust in individuals managing companies. In every emerging market country we avoid industries where the government explicitly bars foreigners from ownership, and in every emerging market we avoid exotic corporate structures. We have, therefore, never owned a VIE structure and have no idea whether VIE structures will in time be legalised, or if the PRC (People's Republic of China) may ban them. As a result, we have chosen not to expose clients to the risk.

Sector bias

We also avoid industries which are obvious targets for more authoritarian regimes. For example, we do not own a single media company in China, or indeed anywhere in emerging markets. Also relevant are companies holding huge quantities of personal data of citizens – these have clear political and ethical risks which we would prefer to avoid (and in China have avoided). The data held by telecoms companies, and by many internet companies, is a huge and often unregulated asset and is therefore vulnerable to a change in political thinking.

In our view, the more embedded the likes of Alibaba and Tencent become within the Chinese economy, the more difficult it is for these companies to remain plausibly independent from the State. This isn't necessarily unusual in emerging markets but when coupled with China's surveillance state, be it the monitoring of online data or the use of social credit ratings, there is clear reason for caution.

Education sector

These risks are playing out in the education sector which the PRC has recently turned its attention to.

We have often met, but have never owned, a Chinese education company. Nor have we owned companies with similarities to the Chinese education company business model across emerging markets. We not only see several risks in ownership, but also have some ethical questions as the business model may depend upon exploiting parental fear of a child's success. This has ethical issues for us, and those ethical issues may be acted upon by politicians.

We believe the main risks to owning Chinese education companies are as follows:

- Foreign investors hold these companies via the VIE structure.
- The content of education, and the syllabus taught, is in all countries a political issue but especially in autocracies where a private sector company risks being on the wrong side of syllabus changes. Even an accusation that they are is very risky.

- The founders of several Chinese education companies have, to our minds, quite mixed reputations. In addition, the accounting of some Chinese education companies has in the past been publically questioned.
- The valuations of Chinese education companies, prior to action being taken against them by the PRC, were astonishingly high. They were priced for very high levels of long-term growth in a country whose demographic problems are well documented. We never understood this obvious disconnect.

Closing remarks

At the beginning of 2021, the Chinese government and its capital markets could do no wrong and investors were, as is their tendency, extrapolating a decade or three ahead and paying generous valuations. When emerging market autocracies are being touted as having "the reserve currency of the future" it is usually time to run. Barely six months later, the mood is far more miserable. Typically this is just the pain of short-term loss, although it will be compounded here by the awkwardness of losing client monies invested under capitalist principles in a system as clearly labelled as the "Chinese Communist Party" (CCP).

We have no idea what the next six months will bring, but we highlight two points.

The first is that autocracies appear predictable and pro-capitalist when economic times are good, but ultimately seek little more than survival in more difficult times. Democratic governments seek to remain in power too, but the checks and balances of democratic systems usually see them booted out before things get too bad. The CCP faces no obvious checks and balances and economic times are tougher now in China than they have been for many years, compounded by horrendous demographics. Investors may make money, but it will be a far wilder ride than in the past.

The second point concerns valuations. Although many companies are perhaps 20% to 40% "cheaper" than they were six months ago, the single metric of "decline from peak" fails to recognise how absurd peak valuations were, and also fails to adjust for the high likelihood that under economic stress many businesses will not be nearly as good as they appeared in boom times. We are seeing sprawling internet behemoths valued on "core" earnings. A metric which, to our glass-half-empty hearts, simply confirms that their boom time investments are worthless or (to use the polite analyst term) "non-core".

Investment terms

View our list of investment terms to help you understand the terminology within this document.

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