Navigating the Investing Complexities of China

By: Brian Beitner, CFA, Managing Partner, Chautauqua Capital Management

CHAUTAUQUA CAPITAL MANAGEMENT
A DIVISION OF BAIRD

After the most rapid industrial transformation in the history of the world, China is too big and important for investors to ignore but sits at a crossroad that presents opportunities among some significant risks. Investing success will require an understanding of China's long-range plans and politics, currency, and key trends/concerns in order to truly understand long-term fundamentals that will benefit equities. And, it will be paramount for investors to find companies that not only benefit from favorable trends but also have sizable competitive advantages and high-quality fundamentals. This paper will address the complexities and resulting opportunities.

LONG-RANGE PLANS

China's one-party government is led by people who have largely been trained as engineers with a focus on long-term planning. Since the communist revolution, the command control government has issued multiyear plans that provide clear guidance as to where the economy is headed. Between 2002 and 2012, there was an effort dubbed "Harmonious Society" to shrink the gap between the more affluent urban and coastal Chinese and the less-well-off rural and interior inhabitants. Combined with a desire to maintain steady growth after the Great Financial Crisis, China built (some say overbuilt) world-class, nationwide infrastructure. The ultimate goal was to increase discretionary income to stimulate domestic consumption, which the government hoped would create a flywheel effect to further stimulate economic growth. More recent initiatives under the mantra of "China Dream" have emphasized prosperity, collective effort and national glory. Meanwhile, President Xi has endorsed a "one belt, one road" campaign to build out regional land and ocean transportation systems in Asia.

In May of 2015, China announced a detailed "Made in China 2025" plan. The main thrust of this program is to make China's economy more self-reliant. Therefore, it is expected that certain key industries will be supported and foreign competitors will be placed at a disadvantage. The key industries that China is nurturing, given their focus on growth over profits, may not yet be worthy of investment but may someday be so. Along the way, certain key foreign suppliers may benefit. Western-headquartered leading suppliers of key semiconductor production equipment suppliers will benefit from strong demand as China accelerates its nascent efforts to fabricate their own chips.

POLITICAL LANDSCAPE

2017 is a major transition year for the People's Republic. In February, 3,000 lawmakers gathered in Beijing for the annual People's Congress. This event was more of a pageant to communicate existing policies. Every five years, China holds a more serious closed door "deal making" event called the National Congress of the Communist Party of China. It will take place in the fall of this year and elections will be held for the General Secretary, Politburo, Politburo Standing Committee and the Central Military Commission. It is expected that there will be a major shakeup with as much as 50% turnover among Chinese leaders. What this probably means for investors is that, until they convene, there will be no major risky policy steps taken by the Chinese government. The government will likely continue to work to ensure steady economic growth, but it is unlikely that any new reforms will be announced.

CURRENCY

For the foreseeable future, China will need to keep the renminbi (RMB) in balance with a "weighted by trade" basket of foreign currencies. If it is too low, there will be capital flight. If it is too high, China's export industries will be at a disadvantage. Our current approach is to invest with domestic companies whose costs and revenues are denominated in the same currency so RMB movement will have little effect on a company's profitability.

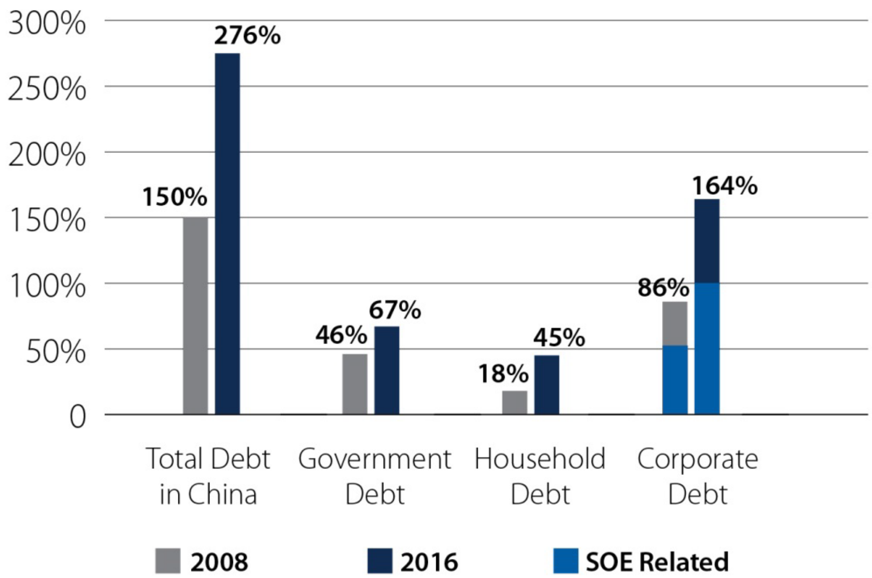
TAKING ADVANTAGE OF KEY TRENDS AND ADDRESSING INVESTOR CONCERNS

Important considerations for navigating China include understanding: 1. high levels of debt, 2. overcapacity of industrial production, infrastructure and housing, 3. an adverse demographic legacy of the 38-year-old "one child" policy, and 4. pollution. Our understanding of these important trends has allowed us to uncover very good investment opportunities while also avoiding a few potential pitfalls.

Debt

Total debt in China has grown from 150% in 2008 to 276% of GDP today. We believe that growth driven by credit expansion is not sustainable and will ultimately be problematic. It is important to understand that the problem centers around State-Owned Enterprises (SOEs). Government debt is 67% of Gross Domestic Product (GDP). That seems reasonable for a large economy; the Organisation for Economic Co-operation and Development (OECD) members average exceeds 100%, U.S. government debt is at 100% of GDP and Japan's is at 200%. Household debt, owing to a high savings rate, is relatively low at 45% of GDP. Corporate debt is high (164% of GDP), of which over 60% is attributable to SOEs. SOE debt represents roughly 100% of GDP.

Debt in China as a % of GDP



Source: World Bank and UBS

Some SOEs are profitable and paying down their debt. However, others are not, and these debt-laden, unprofitable SOEs still employ many people. The government, whose primary goal is to retain power by keeping people employed, even in unnecessary work, is better off supporting these unprofitable enterprises than trying to quell civil unrest among unemployed workers. What makes the situation a little less perilous is the fact that SOE debt has largely been underwritten by the four large banks at the behest of the government. These banks are also SOEs. So, the bad loans are contained. What is more, given China's multi-decade favorable trade balance, they have amassed foreign reserves that approximate 27% of SOE loans.[1] If necessary, these reserves could be applied to restore the Bank's capital. Nevertheless, we are steering clear of the banking sector and avoiding debt-laden, unprofitable SOEs.

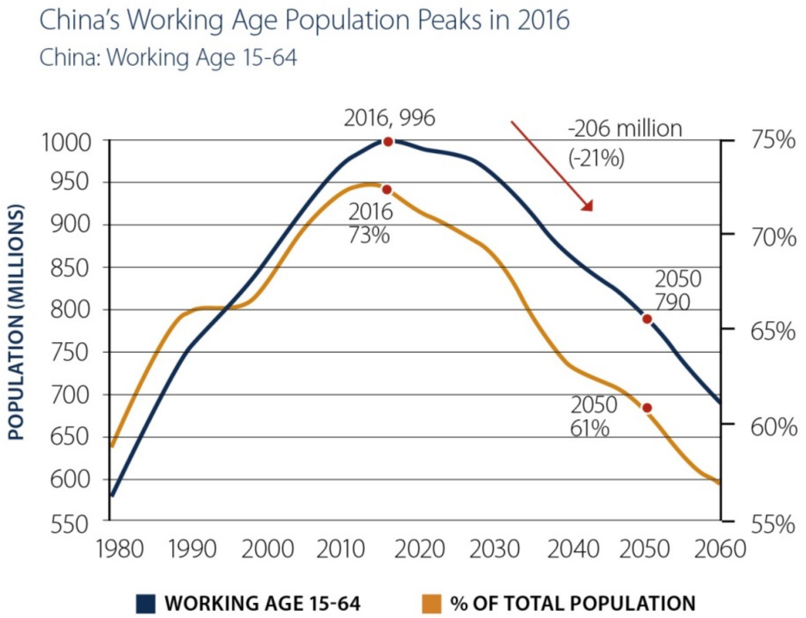
Overcapacity

Overcapacity limits economic growth derived from capital investment. Persistent concerns about a real estate bubble and the government's futile attempts to thwart speculation remain. The counterpoint is that 1. as a nation, China has ample housing, and 2. economic growth is enhanced by its world-class transportation infrastructure. As China continues to grow, it can absorb its excess capacity. It is also conceivable that industrial operating rates will rise as well. The underutilized factories and transportation systems should help China redirect workers from money-losing SOEs to higher-value-added businesses in keeping with the China 2025 plan.

[1] Statistic derived from foreign reserve as % of GDP and SOE loans as % of GDP.

Demographics

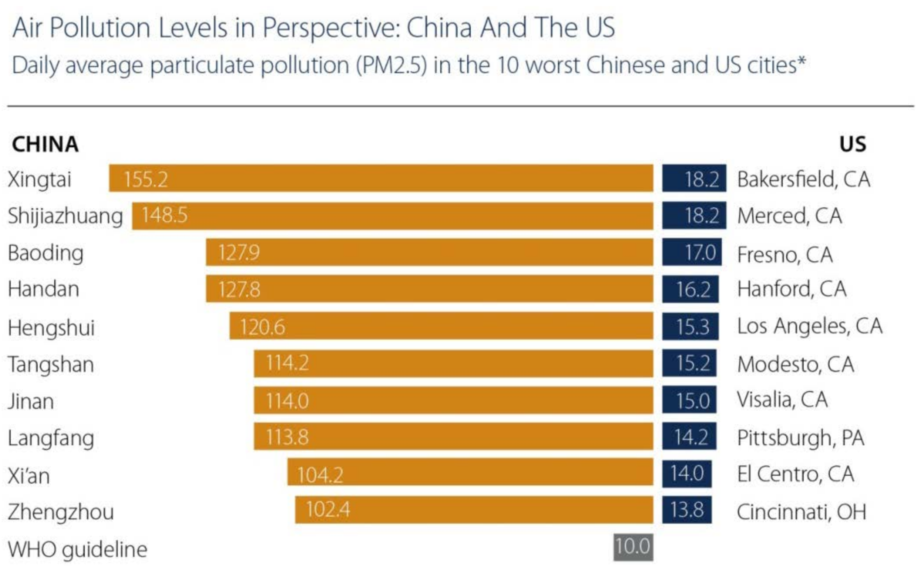
Adverse demographics due to the one-child policy are a palpable future problem. When one productive child must support two parents and four grandparents, there will be an enormous strain on the economy. China has been in such a hurry in part because they need to get rich before they get old. We are now at a point that the retirees are becoming a significant consumer group. They need health care, and for those who saved and realized an improvement in disposable income, they can now buy experiences like travel. Recognizing these trends, we are invested in the leading drug distributor and the leading online travel agency in China.



Source: United Nations World Population Prospects, Data as of May 11, 2011

Pollution

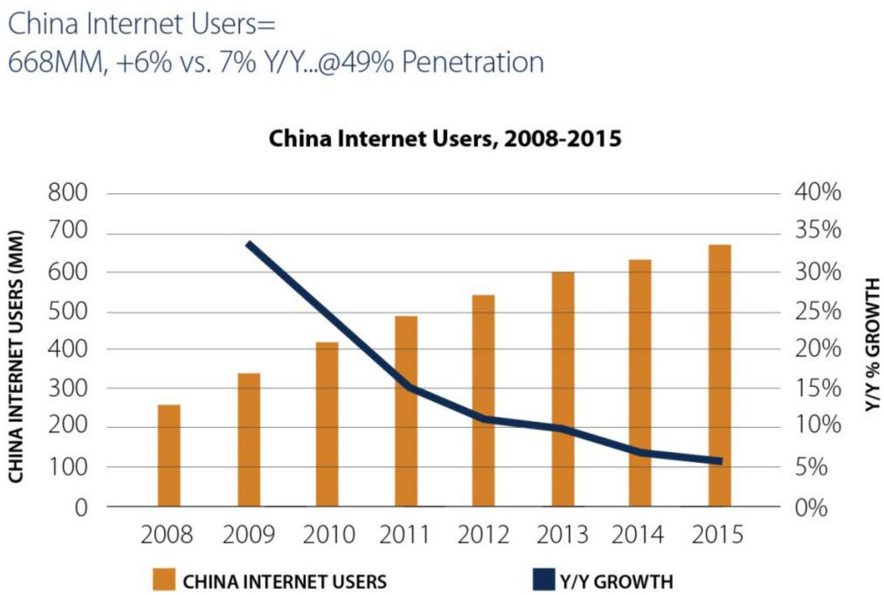
Rapid industrialization has led to some of the worst air and water quality in the world. China has been addressing the problem. China has become a world leader in the use of sustainable energy sources such as solar and wind. Nevertheless, China has a long way to go, and we believe industries involved in clean energy production and nonpolluting transportation will be supported by the government. Add to this a desire to be less dependent on foreign sources for oil, and we believe the electric vehicle industry will grow faster than the overall economy for the foreseeable future. We are investing in the only fully integrated battery and vehicle manufacturer.



Sources: Statista; Washington Post, Chinese Ministry of Environmental Protection, American Lung Association, WHO

E-COMMERCE

In some ways, developing countries benefit from the ability to adopt state-of-the-art technology without having had to follow the prior steps taken in the industrialized world. China's ability to embrace mobile telephony and computing without having to build out complete wire-line telephone networks and use dial-up modems enables rapid internet adoption and significant productivity gains. E-commerce has been and we believe will continue to be a fertile area for investment. We are invested with the leaders who benefit from the network effects and economies of scale of e-commerce.



Source: KPCB, CNNIC

SOEs

Over the next several years, we expect the government to minimize the SOE problem by nurturing and supporting higher-value-added, non-SOE businesses that can create sustainable job growth such that unprofitable SOE companies can quietly be closed down. This shift in the mix should be to our advantage as the companies we own will have a favorable business backdrop.

CONCLUSION

We believe that the growth opportunity in China, albeit slower than in prior years, remains high relative to the rest of the world. At Chautauqua Capital, we have considerable experience in understanding China's long-term planning, politics and key trends. While investing in China has notable risks, on a selective basis we can navigate the complexity of China and invest in fundamentally advantaged, shareholder-oriented companies that benefit from favorable trends. We believe investing in great wealth-creating businesses for the long-term, on a conviction weighted basis, represents the best way to achieve capital appreciation. These embody the hallmarks of the Chautauqua investment process that we have used to build value for clients.

ABOUT THE AUTHOR

Brian Beitner, CFA, Managing Partner
Chautauqua Capital Management

Brian Beitner is the Senior Portfolio Manager for the Chautauqua International Growth Fund and Chautauqua Global Growth Fund. He formed Chautauqua Capital Management in January 2009. Prior to this, he was a member of the TCW Concentrated Core Equities portfolio management team from 1998, which was responsible for the management of up to $27 billion in assets. In 1999, he was named Director of Equity Research. In 2003, he became a Senior Equity Strategist. In 2005, Mr. Beitner began managing International and Global Equity portfolios. Prior to working at Trust Company of the West, he worked with Scudder, Stevens and Clark; Bear Stearns & Co.; and Security Pacific Bank in roles including portfolio management, research, and trading. He earned a B.S. in Public Affairs and an M.B.A. from the University of Southern California, Los Angeles. He holds a certificate for Global Investing from INSEAD. He received his CFA charter in 1989.

IMPORTANT DISCLOSURES

Chautauqua Capital Management is a division of Robert W. Baird & Co. The opinions are those of the author and subject to change.

Past performance does not guarantee future results and diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. Investments in international and emerging markets securities and American Depository Receipts (ADRs) are subject to certain inherent risks including difficulty predicting international trade patterns, currency fluctuations and the possibility of imposition of exchange controls, foreign taxes and regulations, lack of uniform accounting, and the potential for illiquid markets and political or economic instability. These risks are more pronounced in emerging market countries.

Investors should carefully consider investment objectives, risks, charges and expenses of the fund carefully before investing. This and other important information can be found in the prospectuses or summary prospectus. A prospectus or summary prospectus may be obtained by visiting bairdfunds.com or calling 800-442-2473. Please read the prospectus or summary prospectus carefully before you invest or send money.