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The Investor's View

The long game pays off in China

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Among global institutions seeking superior investment returns, a recurring question is, how to play one of the world's most alluring but enigmatic markets - China. Lacking familiarity and knowledge, many institutional investors currently have exposure levels that are not commensurate with China's potentially positive effect on portfolio returns, says Wong Kok Hoi, CIO and chairman of APS Asset Management. "Investors are confident growth will come from Asia, especially China, but they are not investing as much in the region as they should if they seek higher returns," remarks Wong, whose investors are mostly non-Asian institutions. Some large global pension funds have zero direct allocation to China, he explains: "Some of them might have allocations to emerging markets or global funds, so their indirect exposure to China might be minuscule, maybe 0.1% to 0.3%. That's clearly not enough for investors seeking high returns." For an impact on total returns, Wong suggests investors with diversified portfolios need to have up to 10% allocated to Asia, with a 1% to 5% exposure to China, considering the growth prospects over the next decade while developed markets in the West slump into relative decline. China's GDP is likely to accelerate 8% to 10% annually in the next decade. Developed Western markets are projected to grow at 3% to 4% annually. "But mindsets take a long time to change, so allocations to Asia ex-Japan will be low relative to the region's growth potential," he concedes.

Another major obstacle is the traditional definition of risk. "The industry defines risk as volatility of returns, while we define risk as downside risk, which includes overpaying for an asset and deteriorating fundamentals of an asset," Wong explains. According to the traditional definition, Chinese assets are relatively high risk. Analyst Matthew Claassen estimates the Shanghai Composite Index's average rolling five-day percent range of high-to-low during a 90-day period was about 35% higher than the S&P 500's volatility. But according to Wong's reckoning, the risk of overpaying for Chinese assets is currently low. Listed Chinese equities' price-earnings multiples, at about 12 times this year's earnings, are at a five-year low. "Some investors get carried away by growth markets and they overpay for assets. We avoid overpaying," Wong says. He is looking at it within the context of economic growth. Developed Western markets' price-earnings multiples are at a similar level with China's, but GDP growth in the former is significantly lower.

The perception of elevated governance, political and other risks in China is certainly a factor in the low level of investment. Indeed, some funds are wary of Chinese companies because of a succession of accounting irregularities, even among Chinese companies listed in Hong Kong and Singapore's relatively prudent environments. APS manages governance and fraud issues by closely examining the ownership and management of each company before investing. The firm has nine staff dedicated to China, based in Shanghai, Beijing and Shenzhen. They weed out businesses led by people who "create wealth for themselves and not for shareholders," according to Wong." We look for entrepreneurs who create value for all shareholders. We also prefer companies owned by numerous management staff, which provides cross checks on each other, rather than by one shareholder such as a family or a government-linked entity, to minimise instances of abuse. There are enough such companies for us to build a diversified portfolio," Wong remarks. Another strategy is to avoid companies with suspiciously rich margins. "Extraordinarily high margins which are not backed up by common business sense make us nervous.

Very often, we avoid these companies. It's fine for companies to make less money," he says. Of 300 Chinese companies investigated by APS, about 30 have made it into the firm's portfolios. The intense research may have paid off. APS' China-Asia fund outperformed the Shanghai Composite Index by 320% in the last six years.

Although the status quo will change slowly, Wong thinks global investments into China can increase 10-fold over the next decade. He estimates foreign investors currently own less than 1% of China A-shares. "There are two bets investors can make on China. One is a short-term bet that would require getting right the fiscal and monetary policies, near-term health of the global economy, trade relations, exchange rates, current-year corporate earnings and possibly another 100 factors. The easier bet is the long-term bet, on whether China will succeed in its economic modernisation," Wong says. Indeed, amid escalating industrial action by workers such as those in Guangdong and Shanghai, a property market apparently hurtling toward a crash, rumours of social instabilities simmering beneath officially sanctioned data and other developments, China can be unpredictable in the shorter term. "I believe China will succeed in becoming an industrialised nation over the longer term, and the stock market has much more upside, based on the experience of Western and Asian nations. On this premise, we think the Shanghai Composite Index will hit 10,000 points in five to 10 years' time. Wong thinks Chinese corporate earnings growth will thrive on strong long-term fundamentals, although there may be jolts along the way. He reasons that property prices may recede 20% to 30% but not much more because price levels will be supported by large numbers of families waiting to buy. "The population is not much leveraged so consumption won't collapse even if the property markets weaken, especially when the economy is growing. Banks also won't suffer high non-performing loans because many Chinese use cash to buy property. Most of the banks' loans have been to infrastructure projects, which aren't white elephants. Sure, there will be some wastage and leakages but I don't think it will be on a massive scale," he says.

Shane Oliver, chief economist at AMP Capital Investors, concludes that the Chinese economy will manage a soft landing. "The bottom line is that measures to cool the Chinese economy and property market are working and that further tightening is unlikely… The key message from Chinese economic data for May is that the Chinese economy is cooling but not collapsing and that it is continuing to rebalance towards a greater reliance on consumption."

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