RISCURA

July 2021: China Newsletter

Regulation of Chinese Technology Companies

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China in July

After a stellar performance in May 2021, the world continued to make progress on vaccinations, with China reaching nearly 1.2 billion doses. Market volatility was relatively benign (until it shot up again in July!), with the MSCI China and MSCI China A Onshore indices returning +0.1% and -1.8%, respectively for the month.

Growth style gained traction, with Clean Energy, EV, Semiconductor and Biotech having outperformed, while Financials and Commodities detracted. On the economic front, export and industrial profits data remained strong, but some segments such as retail sales started to show softness on growth. We expect the Chinese government to shift to a more supportive stance and the recent reserve requirement ratio cut in July was evident of this.

This month, we review the recent market sell-off and regulatory concerns in the following note:

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China has scaled up its regulatory scrutiny across a number of sectors simultaneously, and over a short period of time... Whilst many of them are linked to the government's objective of improving social equality, they have different reasons and implications.

Media articles mixing all these issues and concluding that China has returned to its "anti-capitalist ways" is something that we see every five to six years. As Ray Dalio of Bridgewater recalls in his latest letter, he has witnessed this before whether it was during the market manipulation of 2015 or the Chinese currency plunge in 2015-16.

"Every time foreign investors interpreted this as policymakers turning away from capital markets, whereas he instead observed steady and fast development of capital markets, entrepreneurship, and openness to foreign investors."

In order to properly understand recent developments, it is important to separately address the changes and the intentions behind them.

However, before doing this we would like to remind our investors that this is a market where outsized monthly drawdowns resulting from mostly retail investors reacting to exogenous events are common and create attractive investment opportunities for skilled investors.

Chinese markets saw incredible volatility recently but none of it unprecedented. This is part and parcel of investing in markets that remain driven by price trend-based retail investors and prone to overreaction from international shareholders. As we have repeatedly said, this is not a market for passive investors. The same applies now with the indiscriminate sell-off over the last week of companies that are exposed to increased regulation but simultaneously to for no reason beyond that they "are Chinese".

"Valuation multiples of growth companies have dropped across the board. Many of our managers are busy repurchasing shares of great businesses that they had only recently sold for valuation reasons."

When investing in China, investors should understand and respect the social objectives of the Chinese state capitalist system. These objectives create significant risks in companies that need to be avoided but also tailwinds for others when policies encourage innovation and development.

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Saying that, Chinese policymakers are behind on regulation and seem to have decided to catch up across multiple sectors all at once. It is safe to assume from their actions in education that they are prepared to be stern if required. This will need to be watched carefully and it has never been more important to have a specialist who knows what they are doing.

This brings us to the need for specialist Chinese managers. China is the world's second largest stock market with thousands of fast-growing companies. Whilst it is too large to ignore, it also requires a skillset that very few global equity managers and only some global emerging market managers have. China requires dedicated specialists who really know what is happening on the ground.

Next is the subject of diversification. We should not apply the same principles in China as we apply to developed markets. China is not a market where concentrated portfolios are better. Firstly, it means that an investor misses out the widest growth opportunity set given the multiple drivers of growth and secondly it exposes the investor to "black swan" events that happen in China more frequently than elsewhere.

"As one of our best managers once told us, he learnt the importance of diversification when he saw his 20% investment in Moutai collapse when the Chinese anti-corruption campaign started in 2012."

It was an exogenous event that he could not have foreseen. Even though the company later prospered, it resulted in significant short-term drawdowns for the manager. This is why we strongly argue for investing across multiple managers specialising in different sectors. For our pooled strategies we have more than 10.

This diversification has helped our investors withstand trade wars, Covid-19 and now this regulatory crackdown whilst enjoying high returns relative to the market indices.

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