Asia Insight September 2011

# China as an Asset Class

China's rapid economic expansion over the last 30 years has allowed many enterprises to grow and prosper. For an increasing number of investors, Chinese stocks have also grown in importance in their portfolios. As modern capital markets have taken root in China, stock markets have become one of the primary channels for companies to raise capital. While China's capital market is still early in its development and has its own risks and challenges, the country is expected to continue to grow and increasingly influence world economies. For a variety of reasons, we believe China is emerging as an investment asset class in its own right.

## What Makes an Asset Class?

Why are U.S. equities considered a separate part of asset allocation? Partly, of course, this is due to home country bias. When U.S. investors look at growing and protecting their purchasing power, U.S. dollar-denominated assets eliminate currency risk and are more likely to grow in line with American wages and standards of living. But even for European and Asian investors, the U.S. plays a special role. It is considered as a separate allocation of their portfolios. Why is this?

We believe the reasons include the size of the markets and economy, the prospects for profitable growth and the diversity and liquidity of the markets. In order to be worthy of the "separate and distinct" treatment, an asset class has to be large enough. Does China fulfill this requirement? Well, in terms of China's contribution to GDP, it is 8% of the world's economic activity. In terms of population, it is four times the size of the U.S. China is surely large enough to merit special attention and is likely to become a bigger part of global economic activity than the U.S., or the whole of Europe in the future. Finally, the combined market capitalization of China, Hong Kong and Taiwan already stands second only to the U.S. in terms of its share of global market size.

## ABCs of Chinese Stocks

China's equity universe is also diverse. It can be divided into onshore and offshore markets. The onshore, or mainland, markets have a relatively short history and are largely closed to foreign investors as the government still exerts strict control on the nation's capital accounts. The two mainland exchanges were established only about 2 decades ago in Shanghai and Shenzhen. However, the speed of expansion of the two bourses has been notable. Thanks to a multitude of new listings, the combined market capitalization for the exchanges reached US$3.8 trillion at the end of June 2011, up significantly from US$402 billion at the end of 2005.

Mainland Chinese stocks have two classes of shares: A shares and B shares, with the market capitalization of B shares at less than one-tenth of A shares. While B shares are open to both domestic and foreign investors, A shares are available only to domestic investors and Qualified Foreign Institutional Investors (QFIIs). Hence, the A-share market is still largely out of reach for most foreign investors. Thus far, overall QFII holdings in China account for less than 2% of the A-share market.

Benefiting from a free flow of capital, Hong Kong and overseas markets have served as the main conduits for Chinese companies to access foreign capital and for foreign investors to participate in China's growth. Positioned as China's offshore financial center, Hong Kong has been a major beneficiary of China's development. Hong Kong's total stock market capitalization grew from US$1.1 trillion in 2005 to US$2.6 trillion at the end of June 2011. Mainland companies listed in Hong Kong now account for approximately half of Hong Kong's market capitalization. Even local Hong Kong companies are seeing a growing portion of their revenue and profit stemming from the rising wealth of the mainland.

## Growth, Yes. But Profitable Growth

The size of an economy alone is not enough to declare a separate asset class. Growth also has a role to play. However, it is not the headline rates of growth that really matter; it is the growth of profit-making opportunities that matters. And it is in this way that China appears to stand out. Its growth has come from increased productivity in the form of total factor productivity (TFP)—the ingenuity with which inputs of labor and capital are combined. China's rate of TFP growth, above 4%, far exceeds that of Western economies, Latin America or other Asian nations. This means that growth is more likely to be sustainable and profitable.

In addition, such growth has been achieved in a diverse range of industries. China has increasingly commercialized its economy, first by embracing market forces and then by transitioning from a centrally planned economy to one that is driven by changing consumer preferences. China now boasts not only the world's largest automobile market but also an economy in which new consumer tastes are emerging in a way that creates opportunities, not only for existing companies, but also for new companies that better understand these emerging consumers. China's once moribund state-owned

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enterprise economy has gradually ceded more power to market forces, capitalist production and entrepreneurial spirit. Investors have access to more of these businesses than ever before—the number of listed Chinese small companies (excluding A shares), has almost doubled over the last five years, numbering more than 1,000 by the end of 2010. Small caps account for two-thirds of patent registration, three-quarters of technology innovation, and four-fifths of new product development and urban employment. Undoubtedly, there are inherent risks to investing in smaller companies and the challenge is in finding those that can establish sustainable, long-term growth and emerge as industry leaders.

## No Longer Just a "Leveraged Play on Global Growth?"

If being a distinct asset class means being treated as a strategic part of a portfolio, the majority of investors probably have not looked at China this way. It has been a very peripheral part of many portfolios—a "leveraged play on global growth," of interest in a short-term, tactical sense. The historical performance of Chinese stocks has been nothing short of a wild ride. The MSCI China Index, which tracks the performance of Hong Kong and B-share listed mainland stocks, reached its all-time high in late 2007 and then plummeted until early 2009. Since then, the market has been in a recovery mode. The Hang Seng Index (HSI) is a benchmark index for the overall Hong Kong market. While HSI is considerably less volatile compared to the MSCI China Index, the risk is still significantly higher than that of the S&P 500 Index (SPX).

The high risk associated with investing in Chinese stocks seems to be reflected in the risk premium demanded by investors. Historically, Chinese stocks have generally traded at a discount to U.S. stocks on a price-to-earnings basis. Given that institutional and overseas investors account for a majority of the trading in Hong Kong, it is not surprising to see that the performance of Hong Kong-listed stocks has shown a high correlation with that of developed markets. But treating China's growth as just an offshoot of Western growth no longer seems wholly appropriate. The phrase "export-driven economy," the conventional caricature of China's development, seems destined for obsolescence as domestic demand in China grows.

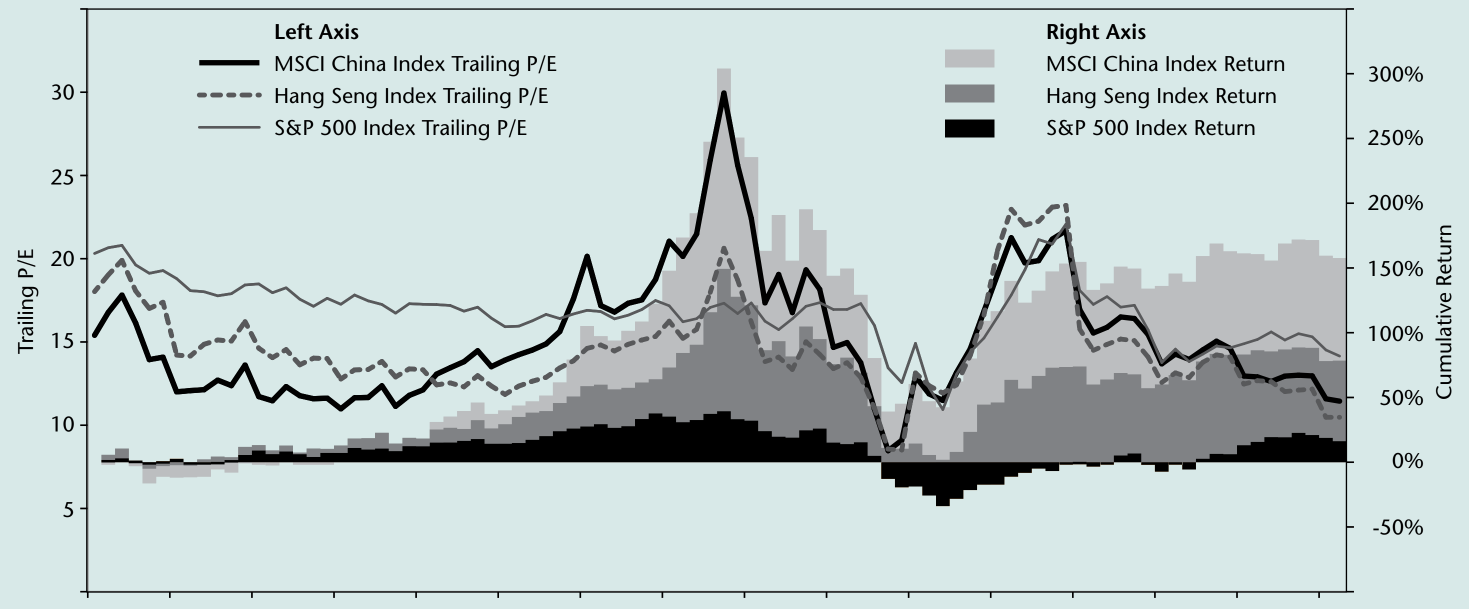
As we start to widen our horizons and treat China as a separate and distinct asset class in its own right, investors should also consider which strategy best suits their long-term aims and goals.

## Strategy Matters

Strategy always matters. However, choice of strategy, which seems second nature when applied to U.S. investments, is still a new concept when applied to China. Once one has decided to treat something as an asset class, i.e., to take a core or strategic stake in its future, it may have an impact on how one thinks about the investments. British economist John Keynes likened it to how one's behavior changes when one makes the commitment to marry: "For this would force the investor to direct his mind to the long-term prospects and to those only."

**HISTORICAL VALUATION AND CUMULATIVE RETURN COMPARISON**

Hong Kong-listed stocks have shown a high correlation with the S&P 500 Index performance




Source: Bloomberg

It is not possible to invest directly in an index. All performance quoted represents past performance and is no guarantee of future results.

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And once you do turn your mind to long-term prospects, it has implications for how you think about things. Take growth for example. Treating growth as a quarter-to-quarter phenomenon is, in our view, less a growth strategy and more a momentum strategy. Our approach to growth, borne as it is out of a strategic commitment to the markets, is to look at companies that we feel can sustain reasonable rates of growth for prolonged periods of time. Thus, we mitigate the effects of short-term momentum and market sentiment on our portfolios by seeking to purchase firms that are both less likely to be bid to extreme valuations and which are more able to sustain growth. In addition, it is hard not to consider allocations away from the large cap companies, once you take a strategic view of China. Small capitalization stocks have been a huge part of the driving force behind China’s growth. They tend to be more entrepreneurial and as we have shown, entrepreneurialism has been at the heart of China’s success.

Finally, many people who invest in China, particularly those who focus on short-term capital appreciation of market averages, are more or less oblivious to the income generated by Chinese stocks. If I am looking to make a tactical allocation (a “leveraged play on global growth”), then why would I care if a company pays a 2% or 5% yield or indeed pays any dividend at all? But if I treat China as a core part of the portfolio, then my attitude may change. Dividends act as a way to extract tangible value from investments and, reinvested, account for over two-thirds of the total returns from Chinese stocks over the last 20 years. With the rapid expansion and increasing liquidity of the offshore Chinese equity universe, foreign investors can access a variety of investment options. For example, Chinese stocks have offered competitive dividend yields. The dividend yields for the MSCI China Index and HSI were 2.5% and 2.9% respectively at the end of June 2011, while the SPX yield was 1.9%. In the past, dividend growth for Chinese stocks has largely tracked corporate earnings growth.

All of the factors previously discussed—size, growth and increasing complexity—mean that China is becoming a separate opportunity set that likely deserves separate attention as part of an investment portfolio. Why does this matter? Does this mean that a client should simply consider a separate China allocation and be done with it? No, I think the implications are deeper. Who would ever approach their U.S. investments by just buying “a U.S. equity fund?” Surely, the decision is more complex. What style of fund? What kind of companies? What approach? The commitment to a geographic area as a strategic part of a portfolio implies that more consideration is made to the strategy one wishes to employ in a region. Indeed, decisions about how to invest in the U.S. are normally made along the lines of: “Do I want growth or value? Large cap or small cap?” It is this same attention that should be given when we consider China investments.


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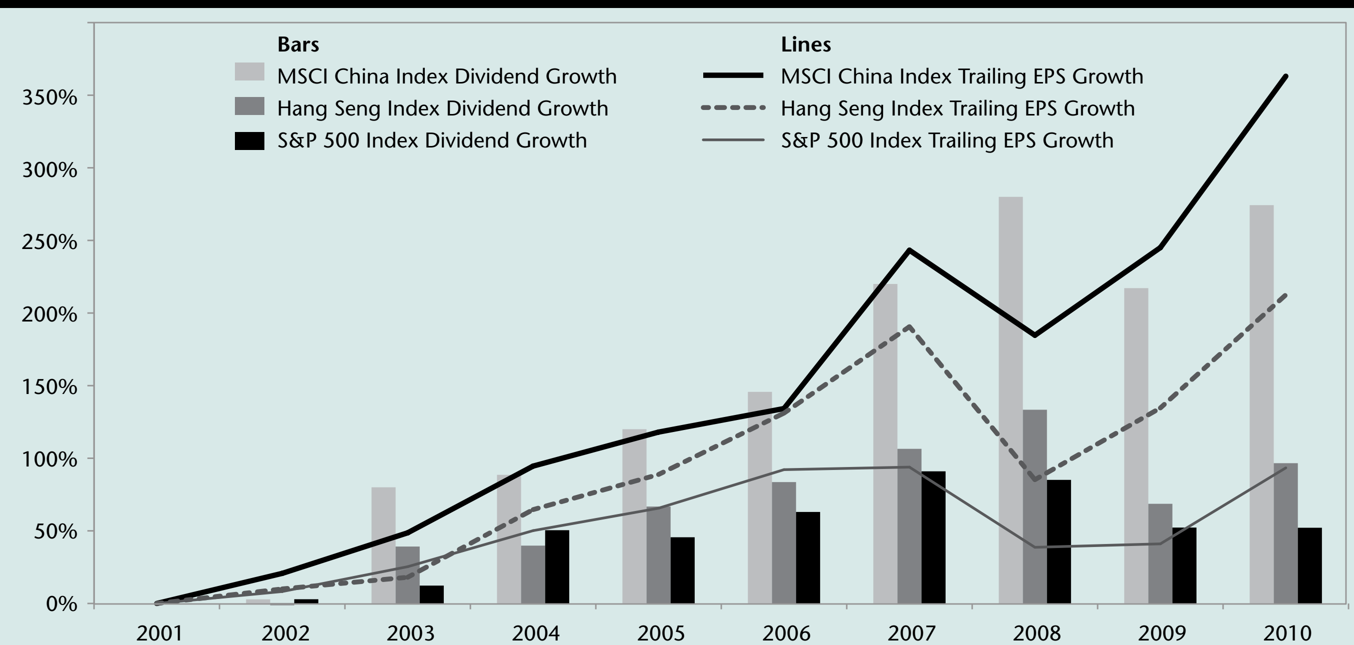
**CUMULATIVE EARNINGS AND DIVIDEND GROWTH**

Dividend growth for Hong Kong-listed stocks have generally tracked earnings growth in recent years




Source: Bloomberg

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MATAI_MICM – September 2011

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