Fundbridge
Bridging the Gap

SPOTLIGHT

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CHINA ISN'T EMERGING, IT'S RETURNING!

Fundbridge has a global, international network, which is a key strength, and builds the bridge between investors and asset managers. In our daily work, we also come across interesting investment professionals who we have worked with and learnt to appreciate over the years. Whilst looking at the latest developments in China, I had the opportunity to discuss China with David Baverez, who has been a portfolio manager in the past, who lives in Hong Kong and who kept close to the market as a private investor. These insights will be shared in the *Fundbridge Newsroom.*

 # Interview with David Baverez

I had the chance to speak with an old friend the other day. His name is David Baverez and I met him in early 2000 when he was still a portfolio manager at Fidelity.

When we first met, he was already one of the most contrarian portfolio managers I had ever encountered. In 2010, David anticipated the European Sovereign Crisis and returned the funds to his investors. He felt 2008 would mark a generational shift and decided to go travelling to anticipate the "New World". He settled in Hong Kong in 2012, but we kept in touch.

Claude Hellers:
When we first met twenty years ago, you were a portfolio manager. Today, you are a private investor, an author and a columnist for a leading French newspaper. What has changed and what do you do differently today?

Shanghai, China

David Baverez:
Nothing has changed. My intellectual curiosity still drives me as I try to understand the world we are living in. The importance of different regions is changing and so are the investment opportunities along with it. What drives me remains the joy of making discoveries.

CH: When we met you were a French citizen living in London. Am I speaking to that same French person who now lives in Asia? And is this a reflection on where you see the future investment opportunities?
DB: Well, you are right. Something has changed. The universe of investment opportunities that I am applying my intellectual curiosity to has been altered. In 2008, the stock market fell 50% in one year. This only happened once in the twentieth century, which was in 1929.

When the Great Financial Crisis happened then, the whole world changed, not for the better. A whole generation became misplaced.

When I look back to 2008, I had a comfortable life. If I had stayed in London and continued to look at large companies from the "Old World", I would never have been able to understand the "New World" that is now emerging.

So, at the end of 2010, I took the unusual step of closing the European fund I was managing and returned the money to my investors. I travelled during 2011 to figure out where this new world was emerging. That is when I arrived in Hong Kong.

I realised that this new phenomenon was being driven by the return of China. I had never seen anything like this on this scale. Approximately 15-20% of the global population were now officially returning to the global economy.

The second thing that struck me was how ignorant I was about what was going on in China. This was despite having access to a huge amount of information when I was based in London.

That's why I believe that over the next 20-30 years I should be able to benefit from this trend. The return of China was something I was unaware of before, along with most my friends in the Western world.

As an investor, you always want to look for something big, which the rest of the world has not seen coming. The major bet I made in 2012 was that the magnitude of the return of China would surprise the rest of the world, and I continue to stick to it.

It has now been eight years since I have been living in Hong Kong. It has been an exciting experience. Every day I learn something new. And the more I learn, the more I realise that I previously knew absolutely nothing about China. The more I learn, the more I feel I still have a lot to learn, which is highly exciting!

CH: When you realised that the emergence of China was big, what were the larger scale themes that you discovered? For instance, was it the political system that you mentioned in your book "Paris-Pékin express"? Back in 2017, you said that the future President of France should learn from China. What was the biggest eye opener for you?

DB: The European Commission just last year deemed China to be a "systemic rival", which I think is adequate. We all have "rivals" in our lives, so we are used to the concept. But, the word "systemic" is interesting.

China has a completely different system from our own so we have spent the last forty years in the West praying for the Chinese system to collapse. However, what we have witnessed has been the opposite. What is fascinating is to try to understand why this system has managed to thrive: how over the last forty years it has managed to reinvent itself at the end of each decade.

That is where I have been spending most of my time. I want to understand how China is going to change post Covid-19 for the next ten years, in the same way it changed after Tiananmen Square, after the Asian Crisis and after the Great Financial Crisis.

CH: You mentioned the Covid-19 crisis. China is now in recovery mode and it is well ahead of us. It may have mastered the situation better than us. Do you think that this will now be a huge advantage for China going forward?

> **"China is going to have to be very friendly to foreign investors to attract more foreign capital in the future."**

DB: The crazy thing is that for the first time in my investing life, we are seeing an economic cycle starting only in China. Economic cycles have always typically started in the US. We used to see it emerge in California and then move on to New York. After that it spread to London, the rest of Europe and then finally Asia. In 2008 following the Great Financial Crisis, the economic cycle started both in the US and in China at the same time. In 2020, we now see economic growth coming only from China. This is something I have never seen before. You cannot be an investor today and say: "I am not interested in China". You cannot be a global investor without looking at China. It has just become impossible.

CH: When you say China, do you mean China, or the Asian region as a whole?

DB: I look at Greater China, which for me includes Taiwan and Hong Kong. That means studying the economic activity of 1.4 billion people, which keeps me pretty busy during the day.

CH: What amazes me is how China has a strategy. It's all in their 5-year plans. Just look at the infrastructure they are developing to help export their goods. Meanwhile, Europe remains more focused on managing what they have now. What do you think about this?

DB: Let's take an example, like the environment for instance. China has just announced that they will be carbon neutral by 2060. In Europe and the US, we very rarely mention goals beyond three years and when we do, we are not able to articulate the execution plan. I find it amazing when China makes such an announcement, they commit to a huge technological gamble of multiplying their solar energy production by 20 times by 2060. China has a very different system.

CH: When you are an investor, you invest in companies. To what extend does the Chinese system represent a political risk for investors? Do foreign investors' exposure to a Chinese company represent a risk? Take for instance, Alibaba. How do you see the political risk for a company like this?

DB: Let me first address the idea of a US-China "Cold War" which for me is rather a "Cold Peace". We are in the opposite situation to 1947: today, the war is impossible, given the existing economic links, but the peace is improbable, given the two fundamentally different systems.

What matters to me as an investor is that, in a "cold peace" environment, China still needs to have a positive balance of payments, it needs a strong currency to attract savings and investments from Europe and Japan, which have for the last forty years been financing the US.

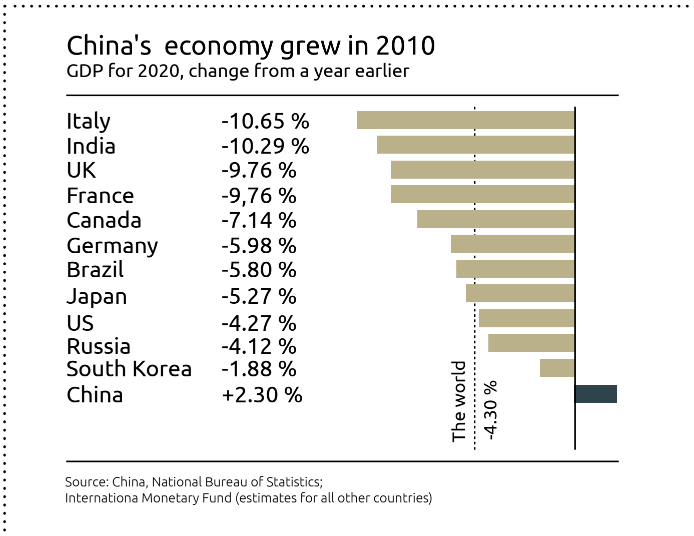
China is therefore going to have to be very friendly to foreign investors to attract more foreign capital in the future. There is a reason for this. When Xi Jinping ascended as the country leader in 2012, the balance of payments for China was hugely positive by the tune of $500 billion. This was because of the trade surplus it had with various countries including the US.

Since then, you have $200 billion at risk from the "US trade war", you also have another $200 billion at risk from Chinese tourists potentially going abroad and spending, and China will need to import more services from the rest of the world. Therefore, the balance of payments for China is now going closer to breakeven, which drives China's need for further foreign capital inflows or FDI (foreign direct investment).

Consequently, Chinese companies will have to become more investor-friendly. That is why for example, they insist that the weighting of Chinese equities in the MSCI Asia should be increased at a time when many of the best Chinese companies are relisting in Hong Kong from the US.

They are also encouraging what is known as the so-called "Northbound connect" with Hong Kong. This is the ability for Hong Kong investors to invest in Mainland China.

There is also China's currency to consider. China has the only central bank of a large country, the PBOC, that refuses to monetise its local debt. What we are seeing is the opposite to what the ECB and the US Federal Reserve are doing. The reason is because China's government and central bank both want to make the renminbi a strong currency. This is the complete opposite to what is happening with the euro and the US dollar, whose devaluation is seen as necessary to reignite growth.



CH: So the opportunity does not come only from good companies that you see, but also from the renminbi currency?

DB: Again, let's take a concrete example. Say you are risk averse and buy the 10-year Chinese government bond. It currently yields 3.2%, plus you can potentially add also 3-4% in currency appreciation per year – the renminbi rose 10% against the US dollar in six months, such a rapid increase I think is not sustainable, but the trend is there.

Let's assume with productivity improvements in China, you will end up with 6-7% return in euros or US dollars per year. This is a dream for any US or European large institutional investor. And, here we have not even started taking on any risk by investing in a specific company.

Amazingly, this is just the return you can get on the currency which is not even convertible! Welcome to a completely upside down world! It is the reason why I have so much fun in trying to understand things which are very counter-intuitive. This non-convertible currency – the renminbi – is where investors will want to put their money.

So, imagine what kind of return you can get if you also add a good stock picker to identify good Chinese companies.

CH: Both of us are European (French and Luxembourgish). We are both probably open to taking risk and investing in Asia. How long do you think it will take before other Western investors discover what you have identified and subsequently, increase their allocation to Asia?

DB: Today, I am told that the exposure of global funds in China is around 3% of their assets, yet China accounts for 15% of global GDP and provides a good third of global economic growth.

This underweight position is going to take years to close. You cannot close it in one or two years. But I expect 2021 to be the first year that there will be a reduction in this underweight position. Fixed income investors will have to go into equity. And within equities, China will increase its weighting for diversification purposes, in addition to the potential growth attractiveness that China presents.

CH: So on the one hand, you have the outlook for China, which is very encouraging: more investors are looking at the region, so you have identified the right spot for opportunity. But let us go one step deeper. When I speak to people in the market, they all seem to favour technology or healthcare for the long term. When you look at China, what are the sectors you find the most interesting? Would you also rather invest in global companies that have exposure to China or in companies who succeed regionally?

Photo by Hanny Naibaho, unsplash.com

Shanghai street, China

DB: The big difference between China and the rest of the world is the narrowness of the market for these themes in the West. For instance, when we say that there is an acceleration of digitalisation in China, this is because digitalisation in China is now invading every sector. Whereas in the West, so far, the vision is that the digital disruption has really affected only three sectors: commerce (Alibaba, Amazon), media (Tencent, Google and Facebook), and the leisure and travel sector (Ctrip, Expedia, and Booking.com).

The other sectors so far have experienced little digital disruption. What we see in China post Covid-19, is the whole service sector becoming digitalised. Here, I am speaking about the financial sector (banking, insurance and asset management), education (whose digital penetration broke the key 10% threshold), healthcare and nutrition.

Each time, it is the same driver: a personalised offering through AI at an affordable cost for people who make $700-1,000 per month. So, the big difference between the West and China is that this big theme of digitalisation can be found in every sector.

CH: I wanted to come back on one point which we touched on earlier. You mentioned that China will be carbon neutral by 2060. In Germany, ESG is a big theme and it will become a key consideration for every investment decision made. We spoke about the "E", what are your thoughts on the "S" and "G" in China? China will probably have an issue on the "S". To what extend do you think that would be a hurdle for foreign investors?

DB: The problem I typically have with ESG is that all of these risk factors are placed in the same basket, while these are three Items that are completely different in nature. Subsequently, China is going to treat them differently.

On the environment, I believe China will surprise us positively, especially in comparison to the US. When it comes to the social aspects, China is going to approach it very differently just because the sociology of China is completely different to our own. For instance, you have had the "one child policy" for thirty years, which means that you have a society of single children, with an unmatched urban density versus the rest of the world.

To give you an example, in Hong Kong, half of its population are living in a tower above the sixteenth floor. This has created a completely new form of family structure, with single children living in a extremely dense urban environment. Therefore, the social organisation will be completely different from the West.

Finally, you have governance, where a company should be aligned with the interests of its shareholders. Personally, that's why I have never invested in a SOE (State Owned Enterprise).

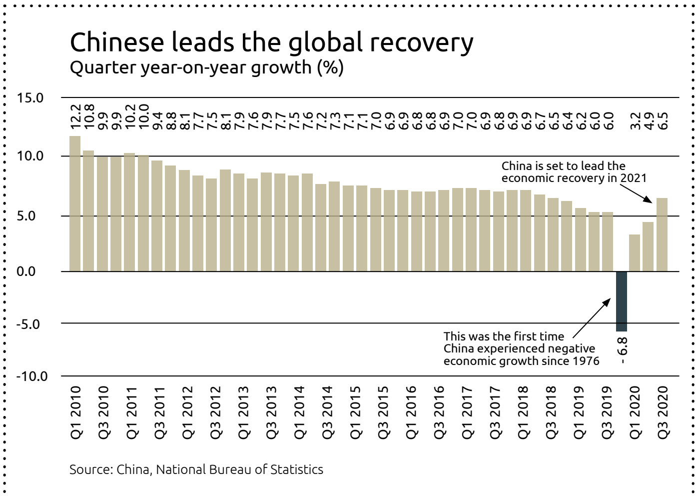
I only look at private companies with a large equity holding held by the founder, in order to make sure that our interests are aligned. We have this perception in the West that most Chinese companies are not profitable. This is completely wrong".

What I find interesting about China is that you can find some very unusual opportunities which you cannot find in Europe or in the US. These are super-growers which are growing their top line by more than 20% and who are delivering a return-on-equity of more than 20%.

Due to the compounding effect, these companies can self-fund their super high growth rates. Even if you are paying a very high multiple today, this multiple can decline over time at a rapid pace and if you can sustain this growth, you are bound to make money.

This is what Warren Buffett calls very high compounders. I can find many of these in China, but I'm struggling to find these types of companies in the West. As a stock picker, there are incredible opportunities in China.

CH: I understand your reasoning on the "E" and on the "G". But on the "S", as an investor you probably need to make some concessions due to the differences in society as you have explained. Will China ever align to the West's standards for "S"?



Source: China, National Bureau of Statistics

DB: I think the problem is that you shouldn't apply Western standards to Chinese companies. Obviously, there are a few things on which we should never compromise, like child labour, which is completely unacceptable. However, there are other aspects of "S" that we define the West, which you cannot copy paste into China.

CH: David I remember in one meeting we had back in London a long time ago, you came with all your financial analysis, annual reports and threw them all into a bin. You said that everyone knows this already, so I need to look at things differently. In a world like today, where you get too much information, where do you get unique insights that help you form your convictions?

DB: The main issue you have with China is that all the official statistics are wrong. You cannot rely on them. So again, let's take a concrete example.

China is usually the first country in the world to give you its quarterly GDP, which China publishes ten days after the quarter end. I never pay attention to these. I rather pay attention to the indication that the government wants to send to the market. That is more important. That's why I take these official numbers with a pinch of salt.

There is no one magic source of information. What you need to do is to multiply the sources where you get information from. There are a lot of industry blogs organised vertically, thematic blogs with high-quality information, which are free to access over the internet.

It is a lot of work and it is very time consuming. There is not one single site I could refer you to. If I get from a source once a year a valuable piece of information, then I am happy. That is the way I am working.

I do not think that AI is the solution because AI tends to send you back to what the consensus thinks.

The biggest challenge that I have is that when I look at an issue, very often, one data point tells me that China is bankrupt, while another tells me that China is number one in the world. To be open-minded, you also need to hear the opposite of what you think. You need to talk to the management teams of the companies you look at and check as much as possible if what they are saying is truthful.

"The West remains dramatically underweight Asia."

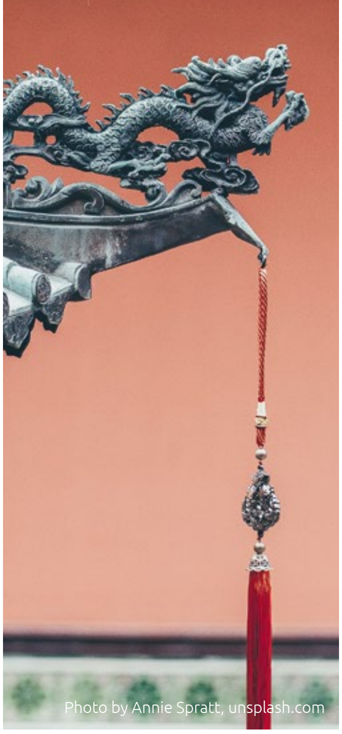


Photo by Annie Spratt, unsplash.com

CH: You have talked a lot about China and you are also a prominent commentator in the French media. We are now at the beginning of the new year. What would be your recommendations be, from an investor point of view?

DB: The biggest risk with China is not with Beijing, it's with Luxembourg, Paris and Frankfurt. It is our ignorance. And for me, this is the biggest country risk we face.

Here is a statistic. There are 600,000 Westerners (including from the EU and US) in Mainland China: 200,000 in Beijing, 200,000 in Shanghai and 200,00 across the rest of Mainland China and they are there to understand 1.4 billion people. Meanwhile, China has a diaspora of 70 million people living in the West. We therefore, have an information disadvantage of 1:100.

So, my biggest wish for 2021 is that we, Westerners, start learning about China, and try to develop an objective unbiased analysis of the country. It is just fascinating to try to understand what is going on there.

CH: Thanks David, I think we have covered a lot of ground. Is there anything I have missed?

No, I don't think so. The most significant point we have touched on today is the mis-allocation of assets: the West remains dramatically underweight Asia, notably China, at a time when the wheel of history is turning.

We need therefore to assess whether our asset allocation is right and whether we have correctly identified those Chinese national champions that are likely to emerge as global champions in the future. If you have not started looking at this yet, you should start in 2021.


David Baverez
Private Investor
(formerly Portfolio Management)