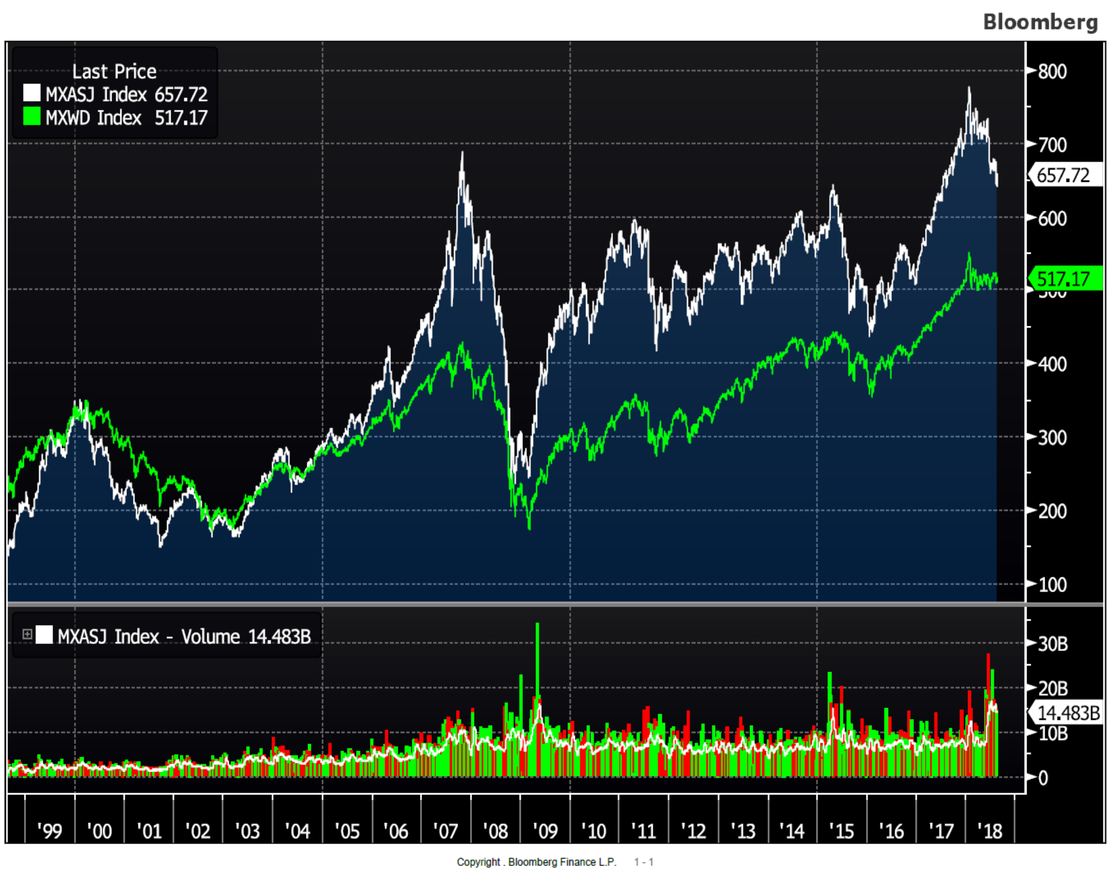
1. Why You Should Consider Investing in Chinese Consumer Growth

If you’ve picked up this book, it’s likely you’ve been wondering to yourself: Should I consider investing in China? Or are there enough investment opportunities in the United States? The short answer to the latter question, of course, is yes, we have plenty of investment opportunities in the United States. However, in order to achieve above-average investment returns you will need to think a bit differently. Robert Frost, in his poem “The Road Not Taken,” tells us: “Two roads diverged in a wood, and I— / I took the one less traveled by, / and that has made all the difference.”[1] This is a reminder that there is real value in going off the beaten path.

Some Americans have been burned by foreign equities in the past. And knowing this, you may lack conviction. Following the nine-year bear market in U.S., European, and Japanese equities (2001–2009) and a collapse in the real-estate market, who wanted to open their 401k statement or talk to a Wall Street broker? Many investors associate disproportionate risk (and lack of return) with international investing. But this is not the case when allocating to all asset classes, over the long term, to achieve risk-adjusted positive returns. International equities, and

China in particular, are part of a long-term investment portfolio. The recent bull market in the United States has been positive, but investors want more. So let me suggest an alternative that has documented historical returns, good management, and considerable market opportunity: Asian equities. Maybe you've already heard of some of the stars. There's Baidu, the Google of China. And Taiwan Semiconductor, also known as the Intel of Asia. And the most prominent, Alibaba, the Amazon of China. All are interesting examples of Asian corporate excellence and offer significant investment opportunities.

We have done a comparative analysis of major asset class returns over the last ten and twenty years. Asian equities rank first in comparative returns versus global equity over both periods.



The white line is Asian ex-Japan Equity and the green line is the MSCI All Country World Index. Over a twenty-year period, Asian equity (fueled by China) has outperformed global equity as expressed by the most commonly used global equity benchmark: the ACWI or MSCI All Country World Index (which does hold U.S. stocks as well).

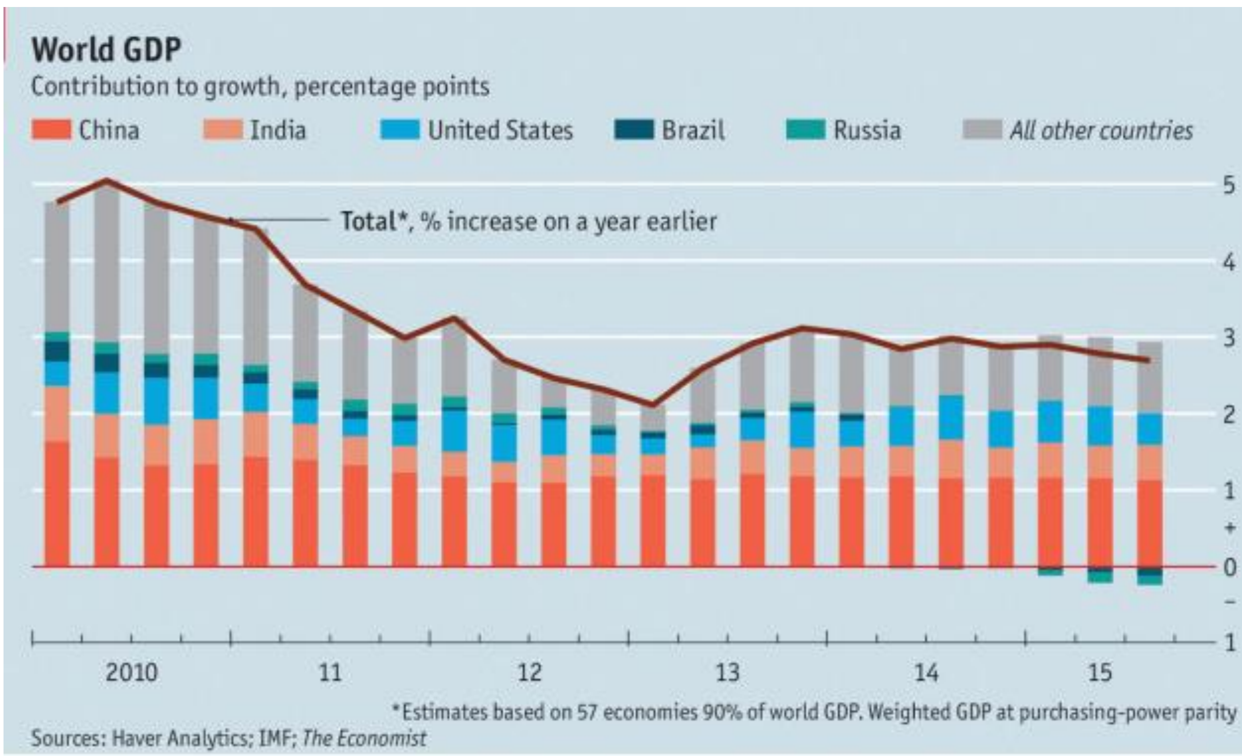
Investors *think* Asian equities have underperformed over longer periods, but the opposite is true. What is important is to examine the facts about financial returns, not popular belief. While it is true that Asian equities have higher volatility, the negative coverage of China in the media is due more to politics than the economy. For a number of reasons, the conventional wisdom in the United States is that domestic stocks, bonds, and real estate will give investors the best financial return. This U.S.-centric investment axiom has been true for select periods, such as the late 1990s or the 2010s. However, when doing a more comprehensive analysis of all liquid asset classes—including commodities, international bonds, and Asian equities—it is clear that the conventional wisdom is somewhat misleading.

Establishing Trust in Asian Markets

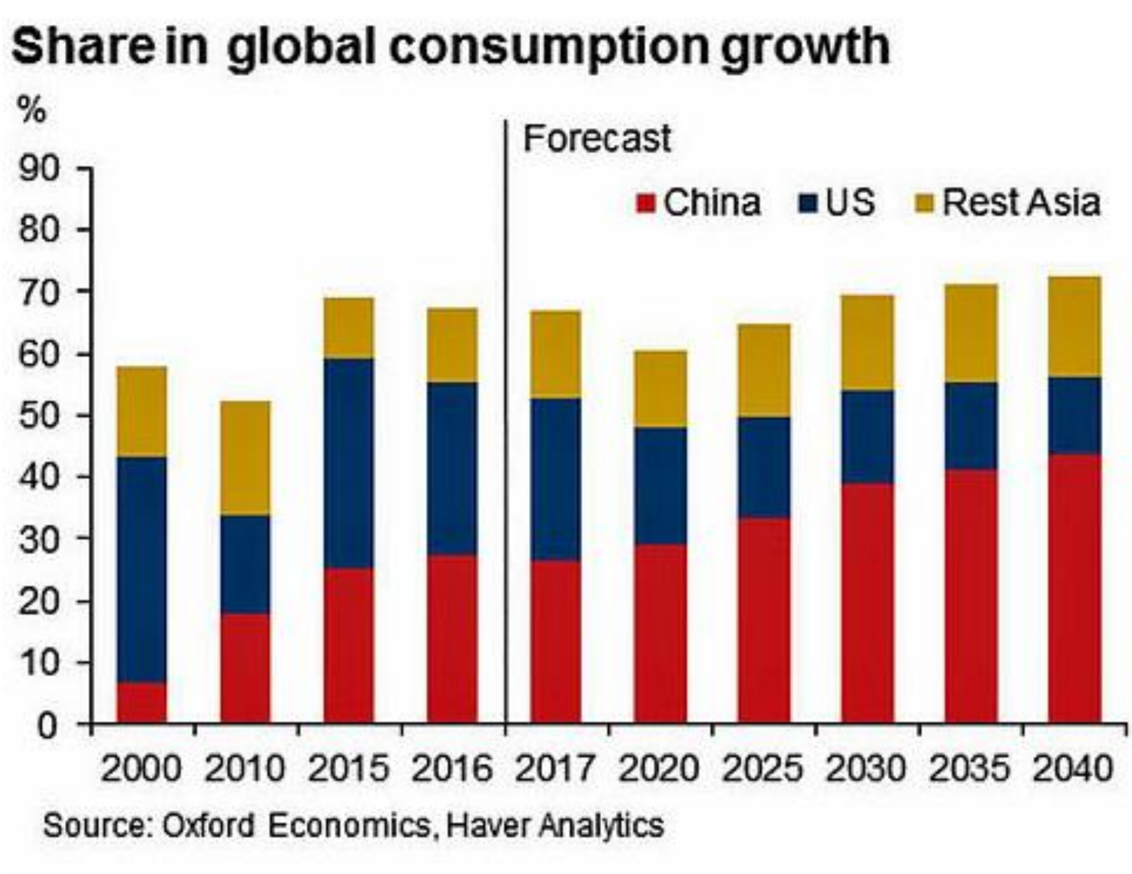
Asian equities have several advantages: relative return, high after-tax return on equity (12%), and consistency of earnings growth (17% per annum).[3] But if asset allocation were only about the highest investment returns, then why are pension funds, endowments, and—most importantly—retail investors shy about Asian equities? Language and culture barriers, different time zones, and politics are all reasons we give ourselves to stay away. However, the purist might say money is blind: it pays no heed to color, politics, philosophy, or religion. It merely seeks the highest return. Over the long term, this is an axiom of capitalism. Over the short term, however, political and cultural biases can harpoon capitalist laws and hinder investment flows. This seems to be the case with Asian equity.

The most common investor refrain is: I do not trust those markets. It is hard to read about reports of shoddy Asian accounting standards, a lack of transparency, corruption, and insider trading. Certainly, Asian corporate fraud has been rampant, but it is not unusual when compared to fraud in every other global market. The Lehman fraud lost almost US$1 trillion and the level of other global frauds puts the Chinese experience in perspective. I do not mean to minimize Chinese corporate fraud, which is certainly very real, but all things need to be viewed in context. As a former Asian equity analyst and current Asian equity portfolio manager, I can assure you that these negative investor comments are relics of the past. The U.S. equity bear market of 2000–2009, complete with two major collapses, should convince people that the S&P is fraught with similar dangers. Certainly, the comparative argument about safety and transparency was settled within U.S. markets during the 2008 collapse.

Benjamin Graham once said that stocks are a voting machine in the short term and a weighing machine in the long term.[4] The weighing machine measures how successful a company actually is—registering things like higher earnings and lower leverage—while the voting machine takes into account how popular a company is—taking into account factors like culture, politics, and religion. One could make the case that Asian equities are trying to avoid the voting-machine mindset and prove themselves in a weight contest instead.



China and India were once dominant global economies, but colonialism, war, and technological and political change contributed significantly to the West's rise in global GDP share. These historical facts are lost upon most Western investors. But the tide appears to be turning, and many individuals and institutions are casting aside historical norms and taking a fresh look at investing in China.



The Consumer Economy in China

Consumerism is the new fuel for economic growth in the Middle Kingdom. The last ten years of Chinese economic rebalancing have unleashed a veritable consumer tiger. While many pundits are focused on the GDP slowdown in China, it is important to understand that this slowdown is due to the unsustainable and unbalanced levels of double-digit GDP growth from 1980 to 2010. The law of large numbers has also taken over, and current economic growth has stabilized at 5% to 6%. If anything, it is a miracle that China has kept growth at around 6%—perhaps an even lower rate would be more sustainable. Do not be surprised by slower GDP growth.

One of the downsides of China's historical investment-led growth is that it has sometimes made consumption appear as if it is decreasing relative to the GDP. This is a result of the unbalanced, supercharged growth from 2002 to 2012. From this perspective, Chinese consumption decreased from 51% of GDP in 1985 to 40% in 2017.[5] By comparison, Japanese consumption accounted for 61% of GDP in 2015, while the United States was at 70%. China's