China Syndrome

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Hot Topics

Fortuitous Timing

This *Commentary* focuses on China — a nation whose changing role in the global economy has become a focal point for conversations among many Americans, especially those who serve on investment committees of endowed charities. One such institution — a fine and well-endowed university — hosted recently an "investment roundtable" for its trustees, administrators, and donors in which TIFF's president, David Salem, was privileged to participate. The essay that follows is adapted from his prepared remarks at this gathering, which focused on two seemingly unrelated topics: "ethics in the investment industry and the rise of China." The adaptation below excludes remarks on the first of these topics because it was discussed at length in our commentaries for 3Q 2003 and 4Q 2003. This *Commentary's* title has two derivations: the 1979 film of the same name starring a gifted American actress who said some regrettable things about her own country during a well-publicized trip to Asia in 1971 and an article titled identically to this *Commentary* on the challenges of doing business in China in the September 2002 edition of *CIO* (as in chief **information** officer) magazine. Ignoring for the moment a large irony respecting contemporary use of the term "China syndrome" — i.e., the fact that China's GDP is unlikely to grow at a rate commensurate with consensus expectations unless it figures out a way to build and operate safely many nuclear reactors — we'll note that if an investor today could anticipate China's future fate as fortuitously as the aforementioned film's producers anticipated the nuclear power industry's, she could realize vast profits: 11 days after The China Syndrome's release in March 1979, America's most serious reactor accident occurred at Pennsylvania's Three Mile Island, where the cooling system for one of TMI's two nukes broke down. Shares of utilities with nuclear plants plummeted on the news, as did broad stock market indices, notwithstanding an upward spike in shares of the movie's distributor, Columbia Pictures.

No Rush

Interestingly — and importantly for investors seeking to gauge the long-term direction of energy prices and hence also real GDP growth both within and outside the US — TMI's **other** reactor (Unit 1) recently completed its 24th year of trouble-free service. It actually commenced operations 30 years ago but was mothballed for six years following the accident in Unit 2. In 1997, TMI-1 completed the longest uninterrupted operating run of any light water reactor in the history of nuclear power (616 days), easily eclipsing the record for steam-driven plants also, all of which are powered by fossil fuels. Some readers may deem these facts inapposite to the chief issue discussed below — whether it's necessary or wise for US-based fiduciaries to invest directly in "China plays" at today's prices — but they are arguably very relevant indeed. Moreover, for reasons outlined below, US-based fiduciaries arguably should be in no rush to invest directly in China. In the 25 years since TMI-2 went down, no new nuclear power plants have been licensed in the US. Given the still-lofty valuations of direct "China plays" — and the still-dominant position of China's ruling party — it could take just as many years (i.e., 25) for the former to become choiceworthy investments for US-based endowed charities. As noted below, such investments could become compellingly attractive at a much earlier date — if but arguably only if the old men's club that rules China today first suffers a meltdown of its own. Even then, one might also want to see the US license a new nuclear reactor — or take other effective steps to reduce materially its dependence on fossil fuels — before investing directly in China: America's continuing failure to do so places enormous pressures on both fossil fuel prices and permissible carbon emissions. Both types of pressure — the first economic and upward, the second political and downward — threaten to limit meaningfully China's future economic growth.

Symtoms vs. Root Causes [Excerpted Speech]

Misguided Things

When the folks who organized today's roundtable told me that it would focus on "ethics in the investment industry and the rise of China," I was puzzled, as I saw no ready connection between these two topics. Upon reflection, however, I realize that they do have something important in common: both have excited passion if not also anger among many Americans, which passions in turn have induced politicians to say and do misguided things. They're misguided because they reflect a failure to distinguish symptoms of the policy challenges being discussed from their root causes. Of course, to an investment professional, cognitive failures of this sort often spell opportunity, if not by buying something that's cheap then by selling something that's dear, and I'll do my best to identify ways in which those of you who steward this fine university's endowment can enhance its **net** returns by pondering dispassionately the **long-term** implications of discernible trends in the investment industry on the one hand and China on the other.

The Long March

I emphasize **net** returns because the root cause of the most talked-about scandal in the money management industry in recent years — so-called late trading — is a business model that creates a woeful misalignment of interests between money managers on the one hand and their clients on the other. And I emphasize **long-term** thinking because I think it's unwise for trustees of endowed charities to forfeit the only true edge that they have as investors by focusing undue attention on short-term phenomena. The edge to which I'm referring is the capacity to establish a potentially winning position and stick with it for a prolonged period even if interim events cause unrealized losses, whether absolute or relative. I underscore the importance of truly long-term thinking because my own assessment of what's been happening in China suggests that it would be unwise for US-based fiduciaries to invest capital directly in that country until certain freedoms become more firmly established there. Indeed, until China's political infrastructure changes as materially as the physical landscapes of its coastal cities have changed since

Deng Xiao Ping began letting capitalist flowers bloom some 25 years ago, investing directly in China could be hazardous to an endowment's health.

Circuitous Routes

I don't deny that there have been and will continue to be attractive opportunities to make money exploiting anticipated changes in China, but I deem it neither necessary nor wise to invest directly in China at this time to profit from such changes. It's unnecessary because there are multiple ways for even the most bullish Sinophiles to profit from the potentially rapid expansion of the Chinese economy without subjecting their capital to the high risk of permanent loss that direct investments in China arguably entail. Indeed, I marvel or rather frown at efforts by some US-based institutions to (quoting one well-managed fund's recent "white paper" on this topic) "swap some US GDP for some China GDP." The operative assumption is that institutional portfolios which are properly and hence globally diversified should display country weights that bear at least some discernible relationship to relative GDPs, prospective as well as current. While conceding that many US-based institutions hold portfolios that remain unjustifiably US-centric — a trait we Yanks may have inherited from the Brits, whose portfolios remain **ridiculously** UK-centric despite heavier average allocations to foreign markets than one finds here in the US — I see no reason for US-based investors lacking direct exposure to China to lose sleep over this fact. Indeed, if some fiduciaries who fret about underinvestment in what appears to be the world's most rapidly growing economy spent less time fretting about what they don't own and more time monitoring what they do, they might find that they're profiting from such growth materially already. This is certainly true of the private equity program with which I am most familiar, even though the persons who run it have avoided commitments to partnerships focusing on Asia in general and China in particular. To be sure, the private investments to which I'm alluding as well as a host of more liquid but still indirect means of exploiting economic change in China could produce losses on average if China takes a turn for the worse. But such losses will likely be much smaller than those produced by the chief focus of my remarks here today — direct investments in China — if China develops less rapidly or smoothly than the current consensus implies.

Key Questions

For US-based investors, the key questions respecting China's recent rapid growth are simply stated: (1) is it secular or merely cyclical? and (2) however rapidly the Chinese economy grows in the future, are there ways for outside investors to participate directly in such growth while also ensuring that they can repatriate capital if China takes a turn for the worse? Tipping my hand a bit, I'll admit that I was tempted to replace the word "if" with the word "when" in the prior sentence, as in **when** China takes a turn for the worse. But I'm getting ahead of myself. Turning back to the first of the two questions I just posed — whether China's relatively rapid growth is secular or merely cyclical — I believe that it's as much the latter as the former. Therein lies a problem, because securities prices today arguably reflect the assumption that China's rapid growth is primarily secular — that the Chinese economy is destined to continue growing much more rapidly than that of its trading partners for a prolonged period. Indeed, the consensus view reflected in global stock prices seems to be that anything which the Chinese can readily produce and export will become relatively less expensive over time while anything the Chinese seek to consume but cannot readily produce will become relatively pricier over time, oft-cited examples of the latter being scarce commodities such as oil and iron ore plus certain highly engineered or high valued-added products. Of course, China does routinely and hence notoriously produce **some** high value-added products: widespread pirating and counterfeiting within China of branded goods and intellectual property conceived outside its borders distorts materially China's economic gains, because imports that would otherwise reduce China's reported GDP get understated. According to published figures, China's GDP expanded at an annualized rate just shy of 10% in the second half of 2003. I don't know how much lower China's growth rate would be if the Chinese actually paid in full for all the pirated intellectual property and counterfeited goods that China consumes each year, but the downward adjustment would be material.

Unintended Consequences

So too would be the adjustment to China's projected growth rate if one debited it to reflect the big impact that our own Federal Reserve's extraordinarily loose monetary policies have had on the Chinese economy over the last few years. The plain truth is that the Chinese economy would not have grown at anything close to the impressive rate notched over the last few years without massive easing by the Fed, which has provided the liquidity needed to keep money flowing **into** China or, viewing the same phenomenon through the opposite end of the international accounting prism, the liquidity needed to keep exports flowing **out** of China. Obviously, the Fed's aim in creating so much liquidity was not to promote economic growth in China but rather, as part of its schizophrenic mandate from our own Congress, to promote full employment here in the US while also keeping a lid on domestic inflation, as measured narrowly and hence inanely by the consumer price index. Alas, in an increasingly globalized economy characterized by massive underemployment in a relatively low wage nation such as China, the Fed's efforts to boost employment in these United States through very low short-term interest rates were destined to produce unintended consequences, including frustratingly slow job growth here in the US during the early stages of the current economic recovery plus — perhaps more worrisomely from a longer-term perspective — so-called property bubbles in China no less than in the US. If you think home prices have reached unsustainable highs here in the US, you should consider what's happening in China, where home prices in the bigger cities are roughly 10 times the average urban household income — an unsustainable condition for sure.

Dilution

I could identify other factors underlying China's recent economic gains that are either non-recurring or unsustainable over the long term — including its environmental and worker safety practices or rather the sorry state of same — but time is short and I'll bring this discussion of China to a close by answering as succinctly as possible the second question about it that I posed a few minutes ago. By way of review, the first question I posed was simply whether China's extraordinary growth of late is properly viewed as secular or cyclical. I can't quantify precisely the degree to which it's one or the other, but I'm quite sure that China's long-term growth rate is not nearly as high as consensus expectations imply. The corollary is that asset prices which assume that China will grow rapidly and uninterruptedly for the indefinite future are out of line, with some being unjustifiably high — the most obvious candidates being shares in so-called China plays — and with others being unjustifiably low, such as shares of manufacturers operating outside China whose future prospects aren't quite as grim as their current share prices suggest. My second question about China reflected a more agnostic view of its future prospects and ran as follows: however rapidly the Chinese economy grows in coming years, are there ways for outside investors to participate directly and profitably in such growth while also ensuring that they can repatriate capital if China takes a turn for the worse? My own answer to this question is no, for two reasons. First, even if the Chinese economy and with it many Chinese companies keep expanding at a rapid clip, this doesn't mean that shareholders in the latter will pocket large profits. Indeed, history suggests otherwise, with share prices in countries whose economies undergo extremely rapid growth performing less well on average than share prices in nations growing less rapidly. Why? Because the fast-growing firms we're talking about tend to float more and more shares to finance their growth, thereby causing bottom line earnings per share to grow far less rapidly than top line revenues.

Folly

The second reason it's neither necessary nor wise for US-based fiduciaries to invest directly in China at today's prices is because I believe that opportunities will arise for them to do so at more attractive prices at some future date. Why? Because I doubt greatly that China can combine capitalism with one party rule on a more or less indefinite basis, nor do I believe that the old men's club which runs China today will yield control in a peaceful and orderly manner. To be sure, China's unelected leaders **seem** to have accomplished what no ruling clique has ever done — namely, separate the political infrastructure of a Leninist state dominated by a single party from the economic arrangements that such a state presupposes: state ownership of all means of production. To the best of my knowledge, no such separation has ever been attempted, let alone achieved — and I don't think it will be by China over time horizons appropriate to the management of permanent endowments such as this university's. A well-functioning private economy requires substantial economic freedom, which in turn presupposes certain political arrangements: an independent judiciary to enforce contractual rights, freedom of expression, and perhaps most importantly the freedom or rather power to discipline if not replace the ruling party if it proves excessively corrupt. I know of no authoritarian government in human history that has been able to sustain monopolistic control of political power within the confines of a developed capitalist economy. None. In China's case, the rub will come when the Communist Party, acting as a contractor or buyer or seller of property, fails to honor fully its contractual obligations — i.e., when it places itself above the law. Alas, China has already done this in an international context, by systematically violating the promises it made when it joined the World Trade Organization.

Iron Grip

Its recent heady gains notwithstanding, China remains a nation characterized not by the rule of law but rather by the rule of men, with no independent legal profession or judiciary to prevent the ruling party from punishing if not liquidating persons who disagree with it. As anyone who's attempted to do serious business in China can attest, the Chinese Communist Party remains corrupt to the core. To be sure, there's plenty of corruption in the US and other western democracies, but citizens can tolerate considerable corruption — and considerable economic misery — so long as they retain the ultimate right to remove corrupt officials. China's citizenry can't do this at present, due to the communists' tight grip on Chinese politics, and a study of Chinese history suggests that the Communist Party's current and future leaders are **very** unlikely to relax their grip without considerable damage to the Chinese economy, if not also considerable bloodshed. China has made major strides since its ruling party began giving human nature at least a modicum of free range in Chinese commerce about a quarter century ago, but its so-called leaders have not come remotely close to taking the steps needed to make direct investments in China by US-based endowments either necessary for achievement of their return objectives or choiceworthy means to that end. As for the thorny question of whether direct investments in the **United States** remain choiceworthy for well-intentioned fiduciaries in light of global economic trends, my **current** views on this topic are "on the record" — in the form of an essay on economic development and education (the single most reliable indicator of a nation's evolving competitiveness) that appeared in the TIFF *Commentary* dated March 31, 2000. For better or worse, nothing that has happened since its publication four years ago has altered my view that America's best days may lie behind it if we don't do to this nation's public school monopoly what the people of China should and arguably will do to the Chinese Communist Party's political monopoly: break it once and for all time.