Investing in China: Silk (Road) Purse or Sow's Ear?
An Interview with Scott Malpass and Jay Willoughby

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Introduction

In the recent past, American investors' views on China have rotated from unblemished enthusiasm to substantial caution. From the radical reforms of Deng Xiaoping in 1978 until quite recently, we absorbed a flood of good news from China, punctuated by the awful Tiananmen Square massacre of thirty years ago: the country had the world's highest economic growth rate, hundreds of millions of people were lifted out of poverty, and personal freedoms expanded along with the economy. Chinese products became part of the everyday experience of American consumers, as well as an integral part of the supply chain for American businesses. China essentially became the manufacturing division of the United States and other First World countries.

More recently, however, the U.S.-China relationship has taken on a different tone. Allegations of unfair competition by China, continued surveillance of its own citizens, and reports of repression of minorities have accompanied a generally less friendly relationship. A military buildup and strong language concerning the status of Taiwan and Hong Kong have added to concerns that China was regressing – at the same time that its economic growth was observed to be slowing (not a big surprise for what is now an upper-middle-income economy).

Because several observers whom I respect have recently advised caution regarding investing directly in China, with one, the author and investor Simon Lack, going to the extreme of saying, "If you invest in China it should be through the S&P 500." Lack, drawing on work by the journalist Jason Zweig, asserts that emerging-market returns often lag GDP growth, and that "American[s]...are accustomed to a market with the world's toughest rules, all designed to promote fairness...but it's easy to assume that America's standards are global, which they are not."[2]

Thus, I decided to check out the views of two other longtime China observers and investors whom I also respect: **Scott Malpass**, CIO of the University of Notre Dame, and **Jay Willoughby**, CIO of TIFF Investment Management (TIFF), where Scott is board chair. I sent them a set of questions in advance to frame our conversation. We spoke on May 29, 2019. Here is an edited account of the discussion.

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[2] Lack, Simon. 2019. "Why You Should Only Buy China Through the S&P 500" (blog post, May 29), https://sl-advisors.com/why-you-should-only-buy-china-in-the-s&p500

Scott Malpass
Chief Investment Officer
University of Notre Dame

Jay Willoughby
Chief Investment Officer
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What are your overall views on investing in China?

Larry Siegel: What is your point of view on China as a long-term investment at this time? I know already that both of you have a bullish or above-benchmark weight in China, and specifically in A-shares, which are traded in Shanghai and Shenzhen (not Hong Kong). So presumably you also have a bullish view. Jay, let me start with you: what is the basis of that view?

Jay Willoughby: We are optimistic about China over the next decade and believe that current prices represent an attractive entry point. But I thought that a lot of your prepared questions were those that real skeptics would be asking. We're a lot more optimistic about China than these questions would suggest...

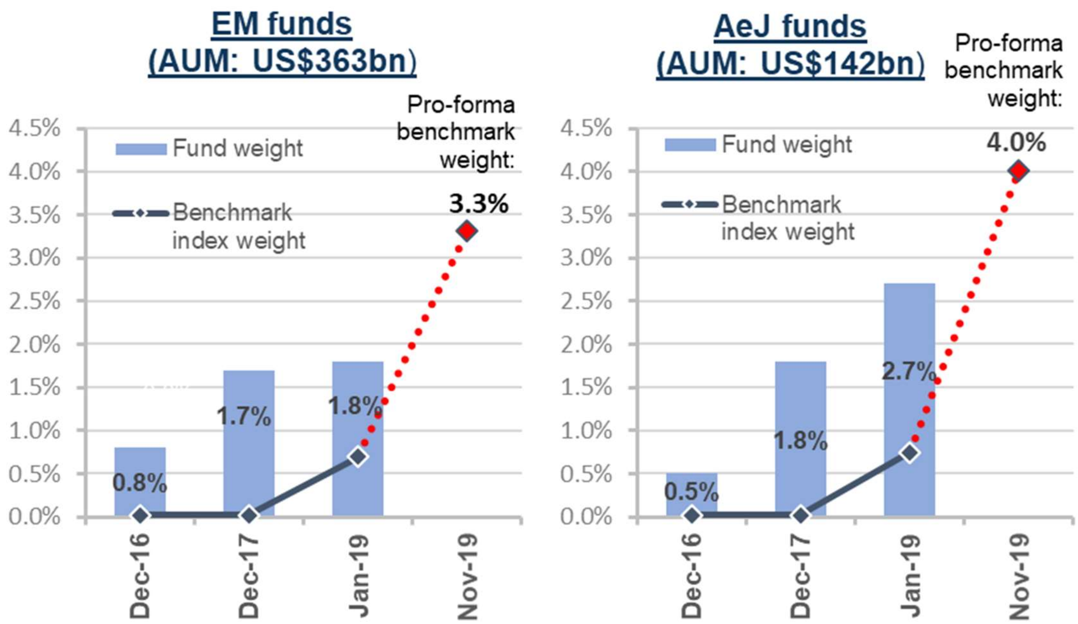
Larry: The questions are probably not unrepresentative of the ones you're going to get from clients who read the newspaper, read *The Economist*, read the materials that their managers send them. I, on the other hand, start with the null hypothesis that the portfolio of all investments, everywhere in the world, is on the efficient frontier and, in that sense, all investments are good or at least neutral. Companies everywhere try to make money and distribute their profits to investors. So asking, "What's the downside," seems natural. Sorry for the interruption.

Jay: No problem. Earlier this year, MSCI was reviewing China's behavior in the capital markets and its rules and laws, and up to this point MSCI had only allowed 5% of the capitalization of the Chinese A-share market to be represented in the MSCI emerging market benchmark.

And, after watching the efforts that China has been undertaking to become a more advanced capital market, MSCI concluded in February 2019 that China has earned more representation in the MSCI benchmarks. The evidence of progress includes the formation of deeper futures markets, and of onshore and offshore bond markets, as well as the A-share market becoming much deeper and more investable. So MSCI increased the percentage of A-share capitalization that it includes in the MSCI emerging market benchmark to 20%. This is taking place in three 3 steps – to 10% representation in May, 15% in August, and finally 20% in November.

Exhibit 1 shows this progression, with the numbers in the exhibit representing A-share capitalization as a percentage of total MSCI emerging market index capitalization. The fact that 10%, then 15%, then 20% of total A-share capitalization will be in the benchmark translates to the smaller (but rising) benchmark weights shown in Exhibit 1, which reflect the weightings of other countries. The exhibit also shows the proportion held by emerging market and Asia ex-Japan *funds*, which is larger than the benchmark weight but still very small.

<u>Exhibit 1</u>
China A-Shares are a Small but Growing Percentage of the MSCI Emerging Market Index, and Are Underowned by Foreigners



Source: Value Partners, based on data from FactSet, MSCI, Goldman Sachs Global Investment Research

Moreover, China has been doing a lot of things that have attracted investment firms like Bridgewater, which has launched an "all-weather" offering in China. Bridgewater wouldn't go to China and set up an operation unless it was meant to be (1) significant and (2) safe. They don't want anyone to be able to steal all their algorithms; they're very careful. And China has been doing all the right things macroeconomically, such as trying to make the renminbi competitive with the dollar.

So with that as a backdrop, China, the A-share market, is the second biggest capital market in the world with second largest trading volume in the world. It has opened up and is a lot easier for people like us, and other endowments and foundations, to invest in. Still, it's far less efficient than the U.S. market because it continues to be driven by retail Chinese investors, kind of like the United States before about 1974. That type of inefficiency is very attractive to active managers.

Larry: I'm tremendously excited about what China has accomplished – as my book, *Fewer, Richer, Greener* (forthcoming from Wiley this October) says, it's the greatest wealth creation event in the history of the world. Against my better judgment, we have to give credit to a system that does not place free enterprise private capitalism front and center. Now, I suspect there's probably more free enterprise private capitalism in China than we think. But there's also a good bit of state control and we would ignore that model at our peril because it has produced a massive amount of wealth and other countries are going to follow it. Anyway, that is my take on the situation. Scott, what is your view on China as a long-term investment?

Scott Malpass: I've been to China at least 30 times, starting six months after Tiananmen Square. I've seen tremendous evolution in all aspects of China. In my first visit, the only cars you saw in Beijing belonged to party officials. Now traffic is massive. GDP per capita then, converted at purchasing power parity (PPP) to today's money, was $3,667 per person.[3] Now we're at $16,760. So I've seen what they've been able to accomplish with modernization and opening up their economy gradually over time.

Going forward 10 years, I think the Chinese broad stock market will meaningfully outperform the S&P 500 due to better starting valuations and stronger growth. China has a massive economy, growing fast, with great companies being built. They're not just copying; they're also innovating in a dramatic way, particularly in the IT sector, which you read a lot about.

Moreover, most members of the Western media don't understand China. You have to be on the ground there to really understand it because the cultural differences are significant. There is a tremendous supply of opportunities today – even in the asset management industry, where there were very few real legitimate players for U.S. institutions to partner with and now you have a large number of such firms.

I'm not saying that it's going to be linear, that it's going to be easy. There have always been some discomfort and complications as they moved along, but over time, the Chinese are extremely entrepreneurial. The regulators have a tremendous number of tools at their disposal to manage the economy and investor behavior. So I am very positive over the long term.

Venture capital and entrepreneurship

Larry: Scott, can you flesh out your comment on innovation and entrepreneurship a little bit for me?

Scott: The Chinese are very entrepreneurial and hard working – it's in their DNA. We invest in the venture capital sector – we have 10 partners there and we have about 12% of our overall fund in China. About half of it is public [equities]. Half is private and the private is almost all venture capital.

We're seeing a tremendous amount of innovation. There are almost as many unicorns – new companies valued at over $1 billion – in China today than in the U.S., across all sectors. Of our top 10 private equity holdings, five of them are Chinese and five of them are American. Two of our largest three are Chinese. And these are companies that most Americans have never heard of. They are not just in the IT sector, but they are concentrated there. The IT sector in the Chinese economy is estimated to be growing at close to 30% annually.

Larry: Whoa...

Jay: We've heard that there is something like 5 million STEM graduates in China every year. And in the U.S. there are fewer than 500,000.

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[3] $1,871 in 1990 dollars, from the Maddison Project database; converted to 2019 dollars using the U.S. CPI.

Larry: That could be a problem.

Scott: The tailwinds for the IT sector include more and better entrepreneurs and engineers, as Jay has pointed out, as well as the increased purchasing power of the growing Chinese middle class.

Growth or value?

Larry: I'm aware of that. Let me move to the next question. The investments that U.S. institutions make in China seem to be Internet or technology related, for example Alibaba and Tencent. Are there more traditional value investments available in China or is the opportunity set a growth set? How do we best capture the returns from Chinese entrepreneurship and inventiveness that we all know are there?

Scott: There are some very large appliance and HVAC companies, for example, that have been developed in China in recent years. We've invested in some of those through our partners. You're right - the IT sector gets a lot of publicity. However, we're seeing a lot of interesting opportunities in the industrial and consumer discretionary sectors. Health care is a massive area of new investment - some of that would be growth rather than value – but, in terms of value investing, appliances, HVAC, and infrastructure come to mind and they're not IT.

Jay: The single largest Chinese holding in our portfolio is Moutai, which is a spirits company in China. Our managers have made big investments in environmental remediation and clean energy, which are much more important to the Chinese than they were 10 or 20 years ago. Real estate development has been huge for a long time.

Scott: Jay, you're making a good point. Doesn't part of the opportunity consist of getting growth companies at value prices?

Jay: Yes. One of our managers, Trustbridge, does public and private equity and we're with them in both areas. On the private side, the founder of Trustbridge, Shujun Li and his partner Feng Ge, built the first private pay hospital in Shanghai. They built this hospital in collaboration with Massachusetts General here in Boston and they're able to witness firsthand health problems and solutions for Chinese people in a way that is critical in improving healthcare outcomes. Improving the health care industry has recently become a significant national priority and we believe will lead to an explosion of Chinese healthcare innovation.

There's another company called Sany, which is a Caterpillar-like competitor there – the biggest excavator maker, they claim, in the world. We went to the factory. They can assemble a big excavator, like a backhoe, in as little as nine minutes. That is how long it takes to put all the pieces together (not including pouring the steel, of course). The pieces come in underneath the floor and hydraulics lift them up onto a conveyor belt. They bolt these huge pieces of steel together, putting them on the tracks so that it becomes a tractor – and in nine minutes it goes from a bunch of parts to an excavator. They build more than double the number of excavators that they built 10 years ago with fewer people.

Robots are another area that gets discussed a lot. Are the Chinese taking U.S. jobs? Without getting into that directly, I can tell you that pretty much every management team that we visited is embedding information technology more deeply into their processes. China had a one-child policy so the labor force will not keep up with the growth rate, and they're trying to replace as many human bodies as they can with robots and make the human jobs a point of leverage for controlling these robots. We hear that idea much more in China than here because they know they're just not going to have the people...

Larry: Haven't they recently changed back to a two-child policy? Or no policy?

Jay: They have, in 2015 or 2016.

Larry: But that change takes a long time to work its way through the population. It will be 20 years before you see the impact at the young end and 40 before you see the impact at middle age. So, yes, they should be prepared for a labor crunch.

Is China an alpha or beta play?

Larry: Do you see China as more of a beta or an alpha play? And what asset classes are you focused on most?

Scott: When we first started investing it China about 15 years ago, we thought of it as an alpha play. The market was so much less efficient – there weren't really a lot of people spending time there like we were. Only a handful of U.S. institutions were there, and we believed that a really talented partner could earn outsized returns. We knew the economy was growing fast; over time we wanted to participate in that, making it a beta play as well, but it was more the inefficiency of the market and the lack of capital that attracted us.

In the private equity markets, the discount on private valuations was massive relative to the public markets. That's what makes a great private equity market whereas, in India for example, there's not much of a discount on the private side; in fact, private is often at a premium.

At this time, I think investors should look at China as both an alpha and a beta opportunity because it has developed so much and, as Jay said, with their economic growth rate and ongoing government reforms and structural reforms taking place, beta is also going to be pretty good. That wasn't the case 20 years ago; for many years the Chinese A-share market was flat. We were achieving returns north of 20% a year in the handful of fast-growing companies our partners had invested in.

Private equity and venture capital in China

Larry: We're in an age of intense interest in private equity. Where is the Chinese market today in that regard?

Scott: In 2018, over $200 billion was raised in China in early VC and private equity funds. That's about the same as what was raised in the U.S.

Larry: That's a *huge* number...

Scott: Even the number of deals – 10,000 or 11,000 deals – is almost the same as in the U.S. While China has violated World Trade Organization (WTO) rules – they have copied U.S. technology and not protected intellectual property – they are also innovating massively. This is a big change that I don't think people fully understand. There are a lot of great companies, like Alibaba, Tencent, and Gree, which is an appliance maker. There are most certainly world-class companies in China.

Jay: When people hear that $200 billion number, they're going to think that's really large, like you did. You have to put it into context. Many Chinese students came here to study and then got jobs in Silicon Valley. Now they're leaving Silicon Valley because there are better opportunities "back home in China." So, it's not as though the money is arriving without an opportunity to put it to work. The whole ecosystem is being built out incredibly quickly, the same way that the whole economy is expanding.

Volatility in the Chinese market: Good or bad?

Larry: Isn't the Chinese equity market awfully volatile?

Jay: We do expect significant volatility in China and view it as one of the attractions of the market. We're more active on the public side than on the private side in China and our three public equity managers have added significant positive returns per year, in aggregate, in the time since we hired them, in up markets and down markets, relative to the Chinese benchmarks.

Volatility is exciting when it's to the upside and painful and depressing when it's to the downside. If you can last through it, it's a good thing because our managers can take advantage of retail investors' exaggerated sense of fear and greed by selling at high prices and buying back at attractively cheap prices. So, even though one ordinarily thinks of volatility as a bad thing, it's a good thing when you have a sophisticated stock buyer working on your behalf in a marketplace that's 75% dominated by retail investors.

Larry: That's an interesting perspective. The theories tell us to hate volatility. I see how it could help you if you know the underlying values of securities.

Scott: We're going to see further discomfort manifest itself as China progresses toward a full-fledged advanced economy. The China/U.S. trade war and a weaker global environment complicate things. But our view is that China's trajectory is intact; because economic cycles exist, the progress will not be linear, but it will be significant.

The U.S.-China trade "war"

Larry: The current U.S.-China trade spat – I don't want to call it a war – has affected many people's outlook for investments in China. One media commentator said this is not a spat; it's the beginning of the end of a loose 30-year alliance. How do you react to that concern?

Scott: I couldn't agree less.

Larry: Good. I'm fishing for reasons to ignore the drumbeat of pessimism. So far, you're doing well, but what about the politics?

Scott: Do you think the Chinese want to be Russia?

Larry: No one wants to be Russia, not even the Russians.

Scott: I promise you China doesn't want to be Russia. They want to be the U.S. They just want to do it in their own, uniquely Chinese way. I can't think of one reason why the U.S. and China should not be long-term partners in multiple ways. And I think that will happen. The Chinese think long-term, beyond this administration to the future. They're going to be one of the winners in the rest of this century and I wouldn't bet against them. They would much rather model themselves economically in so many different ways after the U.S.

Jay: Just to summarize the political issue, I think everything Scott said is true. We have an issue we need to get through. It's an issue between our political leadership and their political leadership. But I think that if you go to China, you're going to find that the people in China think in very much the same way that people in America think.

Larry: One concern I have about any emerging market is whether the investments are safe from currency risk, repatriation risk, and other international financial risks. Do you think it's necessary or, for that matter, possible to hedge any of these risks? More generally, how do you respond to the concern that we are investing in a country where it's been traditionally hard to get your money back? Maybe that has changed, but, if it has, not everyone knows that.

Scott: It has changed. Realistically, if these were major risks, all foreign investment would stop immediately. That would be disastrous for their economy. We've repatriated money back from China with no problem on multiple occasions. Are repatriation problems a possibility? Sure – they can happen in almost every country in the world. But for legitimate institutional investors, I don't think it's a concern at all.

Jay: We have public equity accounts over there, and we get subscriptions and redemptions, so we've added to our accounts and we've redeemed back from them and we get our money back the next day. We send in a redemption, they liquidate our shares, and they send us the money the next day.

Larry: You're saying these are liquid, deep markets that investors do not need to be concerned about? Managers are routinely redeeming shares denominated in renminbi, converting the proceeds to dollars, and getting the dollars?

Scott: You bet. I actually don't know of one instance where an institution was not able to get their money out.

Debt in the Chinese economy

Larry: We have heard a lot about the high level of debt in the Chinese economy. What's going on with that?

Scott: Relative to assets, Larry, what appears to be an enormous amount of debt is actually not that big. There have been excesses in some companies, and some individual sectors. In the aggregate, it's something they're now managing more carefully, and it doesn't feel as large as the press describes it.

Jay: I'll pile on a little bit. Globally, aggregate debt to GDP is about 318% according to the Organization of Economic Cooperation and Development (OECD). In China they say it's 247%. The Chinese government supports the Chinese banks which support the Chinese state-owned enterprises (SOEs) which support this and that, so in some instances it's the same debt counted over and over again. If the Chinese government just lent money to the end user, instead of lending to the bank who lends it to the SOE who lends it to the end user, you wouldn't see three or four iterations.

China's government debt is less than 50% of GDP. Ours is much higher than that. Their corporate debt is much higher, and our corporate debt is lower. So, in aggregate, the two countries' debt positions are actually pretty similar according to the OECD.

In addition, most Chinese debt is in renminbi. As long as you have debt denominated in your own currency, you can print more of your own currency and pay it off. In addition, the government owns something like 50% of all the SOEs, with institutional and retail investors (domestic and foreign) owning the rest – so "state-owned enterprise" is a legacy term that is not fully descriptive. These enterprises are a big component of the A-share market. It's a communist country so they own all the land – you rent it for long periods of time, but they do own it. So, I think their balance sheet is better than a lot of other people's.

Communist country or capitalist one-party state?

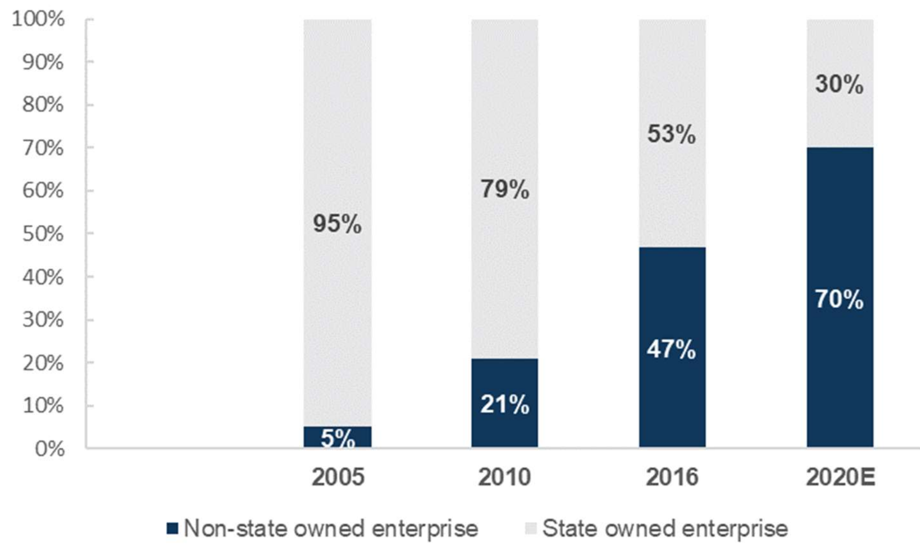
Larry: We traditionally think of a Communist country as one that *only* has state-owned enterprises and obviously that's not the case in China. Is China a single party state where the party is called Communist for historical and traditional reasons, or is it a Communist country?

Jay: I think your first definition is the accurate one. The Communist Party is the only legal party and they still have five-year plans and that sort of thing. But it's very much a capitalist country. This all started with Deng Xiaoping, who in 1978 said it's time for China to adopt a capitalist approach. He sent his cabinet to different countries around the world and when they came back, they holed up in a hotel in Beijing and for six months they wrote a plan about how they were going to try adopting capitalism.

They scouted around the country and they asked, where should we start? Should we start in Shanghai? And Deng said no; it's too important a tax revenue source for the Communist Party, in Beijing. So, he said, let's start in Shenzhen. At the time Shenzhen was a fishing village of about 40,000 people down near Hong Kong. So, they made that the first special economic zone. Now, Shenzhen is a real economic miracle with about 12.5 million people and the third largest economy in China behind only Shanghai and Beijing. In 1992, when Deng visited Shenzhen, he said that it was 10 years ahead of Shanghai and decided to broaden China's capitalistic economic efforts.

Larry: That was a long time ago. At present, more than two decades after Deng's visit to Shenzhen, the transition from state-owned to private enterprise is much farther along. Exhibit 2 indicates the growth of the private sector relative to the state-owned enterprise sector.

<u>Exhibit 2</u>
In the Near Future, Non-State Owned Enterprises Could Reach 70% of China Market Capitalization



Source: Value Partners, based on data from MSCI, Morgan Stanley Research. E=Morgan Stanley Research estimates

The enigma of Xi Jinping

Larry: Let's skip forward to today. China's leader makes us all a little nervous. He seemed to be pursuing the policies of his predecessors at first. But Xi Jinping says he's an orthodox Marxist and that he wants the Chinese people to learn economics from Marxist textbooks. The free market professors are howling and the whole thing sounds like China is regressing. Are you concerned about it at all?

Scott: Xi Jinping is not always popular with the intelligentsia or the rising wealthy class in China. Most of those people think that some of the things he's done, including getting rid of the term limit on his own rule, was a huge mistake.

Jay: What the Chinese leadership wants more is to prevent a popular uprising. That's the reason they do many of the things they do. So, if Xi starts doing things that the populace really doesn't like, it will end pretty quickly because the people will demand it. The genie is out of the bottle and it's not going back in.

Last word

Larry: You've both been very helpful and informative. I'd like to give each of you a chance to answer the question you wish I had asked but that I didn't. Let's start with Jay.

Jay: The question that we get the most is: What would cause you to reduce your exposure to China? And we tell people that there's an easy way and a hard way. The easy way is, if the Chinese market goes up a lot and valuations approach what we think are rich rather than cheap. To put some numbers to that, Chinese P/E ratios today are around 11- or 11.5-times forward earnings; in the U.S. they're closer to 16 – so, in round numbers, valuations in China are 70% or so of the U.S. level. Exhibit 3 compares valuation ratios and earnings-per-share growth rates in the Chinese A-share market with those in other markets around the world.

Exhibit 3

Chinese equity valuations are relatively cheap on a global basis, and growth rates are high

	P/E Ratio		EPS growth (%)		Dividend Yield (%)
	2019E	2020E	2019E	2020E	2019E
Australia	15.4	14.9	4.6	3.7	5.0
China (CSI 300)	13.9	11.6	17.2	12.9	2.4
Hong Kong	16.4	15.1	15.0	8.6	3.0
India	20.0	16.7	22.4	19.6	1.6
Japan	13.0	12.4	1.8	4.7	2.5
Korea	11.9	9.9	-20.2	21.1	2.5
Singapore Free	13.2	12.3	5.5	7.4	4.3
All Country Asia Pacific ex Japan	14.3	12.7	4.3	12.6	3.0
All Country Asia ex Japan	14.1	12.3	4.4	14.2	2.7
USA	17.7	15.8	4.0	11.5	2.0
Europe	14.0	12.6	2.5	11.2	3.9
World (developed market)	16.0	14.5	3.5	10.7	2.6
Emerging Markets	12.9	11.5	4.0	12.6	2.9
All Country World	15.6	14.0	3.5	11.0	2.6

Source: Value Partners, based on data from FactSet, I/B/E/S, MSCI, Goldman Sachs Asia-Pacific Strategy Research, 17 April 2019

So, we think there's a lot of room there on the upside, but if they did approach levels that we thought fairer, we would trim back at the higher prices.

The other thing that would cause us to trim back is, if for some reason this trade problem morphs into something a lot more serious. If somebody bumped into somebody in the South China Sea and something bad happened, then the world could change for a much longer period of time. That would be a hard way to cut back, but we try to remain open-minded about both the upside and the downside.

Scott: My question would be: What would it take to develop a strong edge as well as a comfort level related to investing in China?

It is not easy. It takes a lot of time. It is a very different culture and has very different traditions. It's still a very much an evolving place economically, politically, and in the asset management industry.

So, you have to spend a lot of time in China and develop a network. We probably have somebody in China every 6 weeks, across our teams. It's a huge commitment.

Our on-the-ground, time-intensive approach is a way to get exposure to China in a thoughtful, rigorous way that most investors are not going to be able to do on their own. If they buy ETFs instead, they should remember that ETFs have liquidity and listing requirements. They tend to hold big SOEs for those reasons, and that's not the consumer market in China that we're trying to capture. ETFs are less than ideal instruments for investing in most emerging markets, but particularly in China. You need to be committed and organized, and most institutions are not going to commit to that. We think that the domestic consumer in China will drive future growth and we want to profit from that.

Larry: Gentlemen, I want to thank both of you very much for your time and the sharing of your knowledge. The two of you made a series of non-obvious points that reflect the time you've spent on the ground in China. Only time will tell if you are directionally right or wrong on China, but you and your respective teams have clearly invested a lot of time in understanding the complex organism that is China. As our readers compare your views to those of others who expound on the subject, it is worth considering how much direct experience each of you has in that country.

I'd add that, given the obvious significance of China going forward, as it transitions to be the world's largest economy, getting the Chinese capital markets at least directionally right will be very important to the performance of virtually all institutional investors over the next couple of decades.

I would like to close with a few observations of my own. They are not quite as sanguine as yours, but they are on balance positive. I'd also caution that I speak as an outsider who has been influenced by the Western media that you've said aren't fully aware of what is going on in China, although I'd give the most sophisticated commentators, such as Niall Ferguson of the Hoover Institution and Ian Bremmer of Eurasia Group, more credit than that and I suspect you would too.

I have the perspective of someone imbued with Western Enlightenment values, which combine an optimistic view of the virtues made possible by economic growth with the classical tragic vision, which says that human nature changes only slowly, if at all. In understanding a country these views coalesce around the idea that good institutions are vitally important. Transparency, adherence to rules, a system of enforceable laws, and political stability make it possible to invest and do business without worrying that laws and governmental practices will change from year to year. China has tried mightily to win the world's respect and conform to global standards in this regard.

However, it is only part way there. Much as China may want to be more like the United States, it is not the United States or the U.K. or Germany, or even India or South Korea or Taiwan. It is only partly free. Yet, as the author and historian Johan Norberg has written,

> The Chinese people today can move almost however they like, buy a home, choose an education, pick a job, start a business, belong to a church (as long as they are Buddhists, Taoist, Muslims, Catholics, or Protestants), dress as they like, marry whom they like, be openly gay without ending up in a labor camp, travel abroad freely, and even criticize aspects of the Party's policy (although not its right to rule unopposed). *Even [being] 'not free' is not what is used to be.*[4]

These many improvements aside, there are aspects to one-party rule, and to rule grounded in Marxism, Leninism, and Maoism, that are inconsistent with a free enterprise economy and a free people. While I believe that China will continue to become richer, more open, and a better global citizen, it is still possible that future upheaval in China, or conflict between the U.S. and China, could cause investors to become separated from their claims. That is my main concern. And I think that many well-to-do Chinese share that concern, as evidenced by real estate transactions that anyone who lives in the western United States can easily observe.

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[4] Norberg, Johan. 2016. *Progress: Ten Reasons to Look Forward to the Future.* London: Oneworld. Quote is on page 158; my italics.

That said, I believe Chinese equities should be treated as a mainstream investment. It is not an edgy proposition. China is just a country; all countries have flaws and vulnerabilities. Moreover, China is no ordinary country: it is the second largest economy in the world and will soon become the largest. As I said earlier, it is the country that has built more wealth more quickly than any other country in the history of the world. The wealth has flowed through to a massive number of people, not a small elite.

We can learn from China's success, and we can participate in that success by investing in public and private Chinese equities. Those investments should be actively managed (because the cap-weighted indices are distorted by large-sized but inefficient legacy enterprises) and timed to take advantage of attractive valuations relative to other global opportunities.[5]

Disclosure:

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[5] For those interested in further reading on these topics, an article by Li Lu of Himalaya Capital, one of TIFF's subadvisors that invests in China, is at http://www.himalayacapital.com/index_files/Discussions%20About%20Modernization%20-%20A%20Look%20at%20the%20Future%20of%20Sino-US%20Relations.pdf. It is an eloquent and very well informed 30,000-foot view, with an appreciation for "deep history."