CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENT: INVESTING IN CHINA: NOT YET

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Investing in China: Not Yet

We have noted with some alarm the latest outbreak of a recurring malady—fascination with China's "vast" investment potential. We share this belief in China's investment potential, but not yet and not now. For investors with large, diversified private equity programs, there are some interesting toe-in-the-water opportunities, but for now the primary reason to study China's economy and markets (public and private) is to better understand the forces at work in the global economy. A few years ago, the *Washington Post* ran an advertising campaign on the slogan, "If you don't get it, you don't get it." Much the same could be said about China and the global economy: if you don't know what's going on with China, you don't know what's going on.

In the public equity markets, the overwhelming majority of listed Chinese securities are state-owned enterprises, subject to the political will of a government that has a host of significant social and economic issues on its crowded plate. In aggregate, these individual businesses served as the linchpin of a vast social welfare system under a command economy and as such, profitability was rarely the primary motivation of senior management. Changes are afoot, as WTO-mandated competition looms on the horizon, but any dramatic shift in mindset will take time. Corporate governance in China remains poor, returns on equity are low, valuations are high, financial reporting standards are weak, insider trading and price manipulation are rampant, and the treatment of minority shareholders is dreadful. The China Securities Regulatory Commission, the authority responsible for policing the domestic exchanges, is working tirelessly to keep pace with the growth of the market, but will continue to find this a challenge.

On the economic front, several commentators[1] have cited analysis by the University of Pittsburgh's Thomas G. Rawski, which concludes that China's GDP growth in recent years is perhaps half the reported 8% per annum—not enough to absorb the legions of unemployed workers nor the steady influx of migrants from the countryside into the cities. Meanwhile, the national banking system is essentially insolvent, urban office vacancy rates are running at about 26%, capacity utililization in many industries is low and pricing pressures intensifying, urban unemployment is rising, and rural incomes (66% of the population) are shrinking under the pressure of falling commodity prices and stagnant wages. The emerging story in China is rising domestic demand complementing continued export growth through growing dominance of global manufacturing. But in the cities, retail sales have been disappointing, as workers salt money away against a rainy day.

More fundamental is the question of whether a capitalist economic system can sink permanent roots and flourish in the soil of an opaque and corrupt political system in which the rule of law remains subordinate to the personal and political interests of government officials. Although the public admission of governmental ineptitude in the handling of SARS was universally hailed as an unprecedented breakthrough in the authorities' willingness to be forthcoming in its communications with the outside world and its own people, what does this say about our expectations of this regime? We *expect* them to be opaque and uncommunicative; we *expect* them to fudge and obfuscate any less-than-rosy economic

[1] Including, most recently, Gary Shilling in a very useful comment on China in the April 2003 copy of his *Insight* publication.

information, including such basic data as GDP growth, unemployment, retail sales, and so on. We *know* that the periodic orations against graft, and the arrests and trials that follow, are public relations exercises that don't begin to address the pervasive corruption running through the system. Where legal recourse against corruption is ineffectual, because government officials are outside the law, investors and owners of assets lack the basic protections necessary for a capitalist system to thrive.

These conditions do not preclude successful investment in China, especially by overseas Chinese equipped with the requisite expertise and at home in a cultural milieu where personal relations are the foundation on which business is conducted. However, they should give pause to western investors accustomed to a more impersonal regulatory environment. China may be moving, at speed, in the right direction, and there is much debate about the possibility of political reforms in conjunction with ongoing economic reforms, but until these are more assured, we would advise all but the most intrepid and well-informed investors either to focus on *indirect* investment in China[2] or simply to learn, watch, and wait at a safe distance.

[2] For example, through managers compiling portfolios of non-Chinese listed companies in developed markets much of whose business is either in or with mainland China.