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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

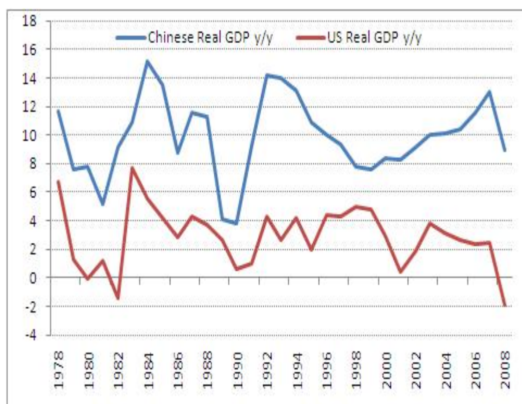
Standard and Poors gives only four American non-financial companies a AAA rating. They are Microsoft, Johnson and Johnson, Exxon, and Automatic Data Processing. There were 60 such companies in the early 1980s.

Federal spending in the last three fiscal years has been 25% of GDP – the highest since the US was mobilized for the second world war in 1945

Investing in China

News of China's economic development is commonplace today. In a matter of ten to twenty years, the "Middle Kingdom" will become the world's largest economy. The transition could even occur this decade if we factor in the buying power of the Chinese currency. China has been there before. As late as 1820, the Chinese produced as much as 30% of the world's output.

Since the economic reforms instituted by Communist party leader Deng Xiaoping in the late 1970s, the country has undergone a transformation without precedent in world history. Economic growth during the past thirty years exceeds even that experienced by USA after the Civil War. 400 million Chinese citizens have been lifted from poverty over this period of time. They are now the world's largest consumer of energy as well as key manufacturing materials such as aluminum and copper. The chart below illustrates the persistent gap between American and Chinese growth rates since China abandoned its "Cultural Revolution"



China's meteoric growth has invited several cautionary tails. This is a country whose economic engine is heavily dependent on real estate and other infrastructure investment., Gross fixed investment comprises nearly one half of China's economy – It's one eighth in the USA. Vacant office buildings and malls dot the landscape. Historically, overinvestment in real estate has led to tears. Our own example lies in the recent past.

Economic development in China has been uneven as growth has been concentrated in eastern coastal cities. Most of the north and west remain backward with restive populations. Chinese president Hu Jintao told George W Bush that that the need to create 25 million new jobs each year keeps him awake at night.

This is a country with significant economic problems. But that hardly distinguishes it from the western economies in which we invest most of our money. The Greek parliament has just approved legislation to implement drastic austerity measures to qualify it for a second bailout from the European Central Bank. Other countries in southern Europe may face the same fate. The debt to GDP ratio of the United States is poised to pass the 100% level as politicians dither over the preconditions for raising our debt ceiling.

Chinese economic growth weathered the storm of the great recession. Its annualized growth rates never fell below 6.2% in any quarter over the past three years. And, so far, its population has absorbed much of the infrastructure that has been built in recent decades.

Another factor is the Chinese currency. While it is impossible to outguess the currency markets in the short term, there is a near consensus that the Chinese currency is undervalued. China has avowed a policy of a containing the appreciation of the Renminbi to support its export industry and job creation engine.

As a result of this concerted effort to depress its currency, things tend to be cheaper to buy in China. A typical consumer item like a Big Mac costs little more than half of what it does in the US. It doesn't mean that the Renminbi will increase next month or next year. It does suggest appreciation against the dollar long term.

It seems reasonable then that we should take Chinese shares into consideration in the context of a diversified investment portfolio. The question is how to invest and how much. The answer is not so simple.

The Chinese indeed have a large economy. However, unlike the United States, many of its companies have not issued shares of ownership. Even those companies that are publicly traded

withhold most shares from the outside investors. About 70% of the shares in Chinese companies are reserved to the government, employees, and other stakeholders. Chinese capital structure doesn't translate into effective ownership of their underlying companies by outsiders.

The US, in contrast, is well represented in world stock indices due to its extensive capital markets. A large fraction of American assets are traded publicly and there are few restrictions on share ownership. The chart below, prepared by David Nadig of IndexUniverse, illustrates the representation of some key countries in the World economy based on different measures.

Country	Market Cap Weighted	GDP Weighted
China	2.39%	9.26%
India	1.00%	2.42%
Germany	2.95%	6.31%
UK	8.11%	4.10%
USA	44.39%	26.76%

". About 70% of the shares in Chinese companies are reserved to the government, employees, and other stakeholders. Chinese capital structure doesn't translate into effective ownership of their underlying companies by outsiders.'

Most index funds calculate the weightings of their components based on freely floating market value of the stock. China presents a major challenge to this methodology. The standard rules of weighting investments would understate the country's true economic influence.

Investors have the option of using the widely traded emerging market funds to get exposure to China. Yet these too are market cap weighted. They significantly underweight China relative to developing markets by a factor of 2 to 3 in terms of GDP.

"There are currently at least 10 broad market ETFs that invest solely in Chinese companies..'

There is another complexity with Chinese investment. The country's stocks are traded in multiple share classes with varying listing, reporting, and ownership requirements. When is a share a share?

Class A and B shares have traded on the Shanghai and Shenzhen stock exchanges since they opened for business in 1990. A shares are restricted to Chinese residents and B shares are traded mostly by locals anyway. Reporting requirements for companies listing in mainland China are not yet up to global standards. About two thirds of China's largest companies are listed *only* on the mainland exchanges.

Many of the larger Chinese companies trade on the Hong Kong exchange as H shares. The shares are denominated in dollars and are subject to the higher listing and reporting standards of the Hong Kong stock exchange. H shares can be owned by foreigners and most mutual funds and ETFs available to westerners invest in these H shares. China's largest banks trade *only* as H shares.

Ironically, Chinese companies listed in the US have been a source of regulatory concern. More than 150 Chinese companies have listed in the United States through reverse mergers or back-door IPO listings since 2007. Here, a mainland firm merges with a publicly listed US shell company, thus avoiding the regulatory rigors of a traditional initial public offering. That said, there are some reputable Chinese technology companies such as Baidu and Ctrip that list only in New York.

There are a number of ways to make a broad investment in China today. At least 10 broad market ETFs now invest solely in Chinese companies. Yet there is considerable variation in what appears to be, at first glance, a similar investment mandate. Most mutual funds and ETFs exclude A shares by necessity as they are not accessible. Thus, a significant fraction of China's publicly traded assets are not in these fund portfolios.

The largest Chinese ETF by asset size is Ishares' China 25 Index (FXI) which invests in the 25 largest companies on the Hong Kong Exchange. Most of Hong Kong's largest companies are banks and energy companies. FXI provides the investor with a 50% exposure to the financial industry while energy companies constitute more than 20% of the portfolio

The next largest Chinese ETFs are State Street's China fund (GXC) and Powershares' Golden Dragon Fund (PGJ). Each is a bit more diversified as their portfolios consist of over 100 Chinese companies. In fact, the Powershares offering makes an effort to include more medium and small cap stocks in its portfolio. Both of these funds have substantially lower allocations to the China's large financial and energy sectors. There are also actively managed mutual funds that focus on China – 26 are tracked by Morningstar. Like the ETFs, most have started trading only recently.

All the China specific ETFs have expense ratios that are a bit higher than those of more common equity index holdings. China is still a relatively new place to invest. Annual fund expenses range from about 0.60% to 0.70%. Despite the high costs, the dynamism of the Chinese economy may warrant special consideration in a diversified portfolio.