The evolving relationship between China's government and businesses

State-owned enterprises (SOEs) — companies controlled by central or local governments — play a special role in China's economy, providing public services, stabilizing the economy, and supporting government industrial policy. SOEs dominate in industries that are of critical strategic importance, including Energy, Finance, Telecom and Transportation. Generally, these companies are inefficient, have lower returns on assets, and higher debt levels than companies in the private sector, and have not been run for the benefit of shareholders. SOEs were compelled to operate in a manner more befitting of national service, often being required to employ more people than needed, or provide products and services that were consistent with government needs — for example, by writing insurance that is not profitable, lending money to meet government objectives, or investing in government initiatives that may not have an attractive return on capital.

The government would like to improve the performance of the SOEs, but without giving up control. Despite this conflict, we have seen signs of progress. The injection of private capital and mixed ownership reforms have allowed selective SOEs to evolve to standalone entities that are competitive in the market, allocate capital efficiently, and install management teams that invest based on returns on capital. Over the past 15 years, we've also seen progress in terms of investor transparency — companies are more responsive to investor questions. We believe the government has realized these changes in transparency and management teams' accountability to investors are effective ways of improving SOE performance, as opposed to just enforcing top-down initiatives from the government.

Investing in SOEs: Know Your Company

We believe it is important for investors to invest only in SOEs that are transitioning to being run for the benefit of shareholders. While some companies have made progress improving their competitive position and transparency, they are in industries that can be especially affected by government initiatives, like banks. Over the years, many of China's larger banks made substantial improvements in upgrading technology, elevating credit standards, and shifting lending towards consumers and private companies. However, the banks continue to be used as a government policy tool, which results in lending to segments of the economy that may not meet pure lending standards. As a result, banks trade at low single-digit multiples — a valuation level unlikely to change until the government allows the banks to run as independent entities without regard for national service. The health insurance industry is also affected by this: The government would like to see companies write more health insurance, but because coverage costs are uncertain, companies are encouraged to write these policies at a loss.

We acknowledge the government needs tools to stabilize China's economy. But, at least for now, most of these policy initiatives are implemented through SOEs. At some point, this will change, and the government will develop alternative tools, allowing SOEs to move to making market-based decisions and allocating capital and other resources effectively for the benefit of the shareholders.

Investors will need to follow developments closely in these industries before committing capital, and companies subject to prioritizing government support should be avoided. We focus on finding SOEs in growth industries that provide a product or service at a price point offering value to consumers and that can produce an attractive return on capital for shareholders. Importantly, we look for companies that are not subject to national service and that share the rewards of success with shareholders as opposed to exclusively funneling profits back into government initiatives.

Emerging Wealth Position

Over the past six months in the Emerging Wealth Strategy, we have continued to allocate capital to Chinese equities as many other investors were reducing their allocation. It is estimated that institutional investors are underinvested in Chinese equities by as much as US$600 billion. Investor sentiment, which was extremely negative earlier this year, appears to be in the process of moving to a more constructive view. We remain conscious that China will continue to face challenges in the months ahead with respect to its zero-Covid policy. While this adds a level of variability to the outlook, one positive note is that the government has modified its stance, reducing the risk of severe lockdowns like those experienced in March 2022. On a longer-term basis, we continue to believe that India and China, the two fastest growing and most populated countries in the world, represent the greatest opportunity for long-term equity investment returns.

Market Performance

For the month ending July 29, 2022, emerging market equities declined by -0.2% and the MSCI World Index increased by 7.9%. Among emerging markets, China was particularly weak with a decline of -9.5%, as challenges in the property market raised concerns about slowing economic growth in the second half of 2022 and rising unemployment — especially youth unemployment. For the year to date, the MSCI Emerging Market Index is down -17.8%, which compares to a decline of -14.2% for MSCI World. The strongest sectors in emerging markets were Utilities and Financials and the weakest were Technology and Communication Services. The strongest countries were those rich in natural resources, including Chile, Kuwait, Qatar, Saudi Arabia, and Brazil. The weakest countries were Taiwan and China, with declines in the -20% – -23% range. Among the larger countries in the Index, India performed well for the month with a 9.3% return and is outperforming the Index with a -7.3% decline for the year to date. In July, Growth (0.4%) outperformed Value (-0.9%), while year to date, Value (-14.7%) has outperformed Growth (-20.8%).

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