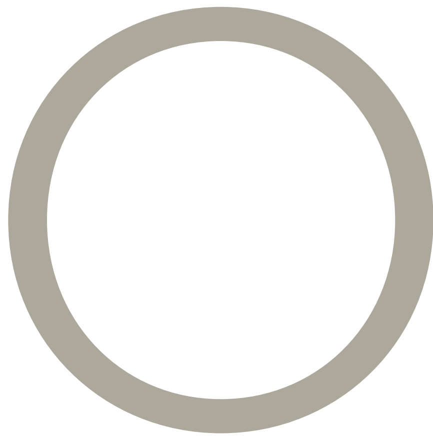

SIR JOHN TEMPLETON INVESTMENT ROUNDTABLE 2018

London | 17th May

JOHN TEMPLETON FOUNDATION | OXFORD METRICA

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KEYNOTE ADDRESS BY DATO' SERI CHEAH CHENG-HYE

Dato' Seri CHEAH Cheng-Hye is Chairman and Co-Chief Investment Officer of Value Partners Group. He is in charge of the Group's fund management and investment research and he sets the Group's overall business and portfolio strategy. In 2007, he led Value Partners to a successful listing in Hong Kong, making it the first asset management company listed in the city. He has over 30 years of investment experience and is considered a leading practitioner of value investing in Asia. Prior to founding Value Partners, he worked at Morgan Grenfell Group in Hong Kong and had a stint as a financial journalist.

Dato' Seri CHEAH currently serves as an Independent Non-executive Director of Hong Kong Exchanges and Clearing Limited since April 2017. He has been a member of the Hong Kong SAR Government's Financial Services Development Council ("FSDC") since 2015, following a two-year term as a member of the New Business Committee of FSDC since 2013. In addition, he has been a member of The Hong Kong University of Science and Technology ("HKUST") Business School Advisory Council since June 2011. He is also Deputy Chairman of The Malaysian Chamber of Commerce (Hong Kong and Macau).

In August 2016, Dato' Seri CHEAH was conferred Darjah Gemilang Pangkuan Negeri ("DGPN"), one of the highest civil honours granted by the state of Penang in Malaysia to recognize exceptional individuals. The DGPN award comes with the title of "Dato' Seri". In 2013, he was conferred Darjah Setia Pangkuan Negeri ("DSPN") with the title of "Dato'" and was named an Honorary Fellow of the Hong Kong University of Science and Technology.

CHINA - THE POSITIVE SURPRISES KEEP COMING

Like Sir John Templeton, who invested in the potential of surprises not yet priced into markets, I, too, am a contrarian investor. China, I believe, will present the world with surprise after surprise, the vast majority of them highly positive and these in turn will open up truly significant opportunities.

It will be one of the minority of developing countries that succeeds in breaking out of the middle-income bracket, that notorious swamp where so many developing countries remain stuck. Those that have broken out from it like Korea are a small minority. By contrast, many of the rest like Latin America, stay stuck at that stage without any chance of light at the end of the tunnel.

Today, China is an upper middle-income country. However, according to Morgan Stanley, by 2027 China will decisively cross the income threshold for a developed country: $12,476.00 per capita income - not bad going for a nation which in the post-war era was at starvation level. Of course, you have to set things in perspective. US annual per capita income is some $60,000. But it is still a major achievement and it presents a wealth of investment implications given China's potential, with its size and growth, to become the leading developed country.

Current Chinese growth is stronger than was expected. It is expected to be 6% this year and 6.5% next year. A recent survey suggests that by 2027 China will be the biggest economy on the planet followed by the US, India, Japan, Indonesia, Russia and Germany. Every four years the Chinese economy is growing by an amount equal to the entire gross domestic product of the UK. Just picture that – a new UK every four years! These are plain statistics, but the evidence really hits you when you're there and notice the expensive BMWs and Porsches on the road. From a financial or investment point of view that is good. But success also brings its problems, some of them unanticipated.

BAY WATCH

One development largely overlooked by the Western media is China's Greater Bay Area. In June I will be among the guests travelling along the world's longest sea bridge connecting Hong Kong with Zhuhai and Macau. 55 kilometers long, it will cut traveling time between Hong Kong and Zhuhai from three hours to 30 minutes. It's an amazing structure supported by artificial islands facing the South China Sea but it is only one of the major projects in what is fast becoming China's huge new Bay Area combining Hong Kong, Macau, Shenzhen, Guangzhou, and Zhuhai and some eleven other cities in a massive metropolitan area. Right now the area contains 67 million people and in itself an economy the size of Russia or Australia. Within the next five years or so it will have an economy bigger than Germany's in 2015.

Another engine driving Chinese growth is urbanization. China's current urbanization rate is still quite low. Compared to developed countries where the urbanization rate for the population can be 80% to 90%, in China it is still below 60%. But the wave of migration to the cities is continuing apace and represents another positive in terms of economic growth, generating huge demand for infrastructure, appliances and indeed all sorts of goods and services.

FROM SUPPLY CHAIN TO DEMAND CHAIN

China is not only now the world's factory – the dominant player in the supply chain. As the world's second largest consumer market, bigger than the entire consumer market of a major country like Germany or Britain, it is also a leader in the global demand chain. Only one consumer goods and services market is bigger than China and that's the US. But whereas the US is a mature market that took two or three generations to get to this point, in China it happened almost overnight. It's staggering to witness.

For example, the Chinese company Midea is today one of the world's largest producers of white goods. Their brand is everywhere. Just recently they just took over one of the top three robotic manufacturers in Germany called Kuka. The German government almost blocked the deal, but finally decided not to. Midea also uses the Toshiba brand for refrigerators and air conditioners and various other products. I can remember visiting Midea in the 1990s. Its factory was in Zhuhai. It was making air conditioners and its brand was much despised. Originally a state-owned enterprise, through a series of transactions, too complicated to describe, it went through a management buy-out and is now an A-share listed company in China

Now China is moving from goods into services. The government is aiming to create a so-called "Beautiful China," with clean air, better quality growth, less wastage, a move away from financial repression, an enhanced rule of law and a better quality of life generally. Those companies that are able especially to offer healthcare, education, travel stand to make a lot of money. People are way past the 'buy a car, buy a refrigerator' level. Very fascinating to observe, this phenomenon is rousing some jealousy in Hong Kong, which formerly was, of course, far richer than the mainland. Big shots from Hong Kong used to go into mainland China and throw their weight and money about. Not so much anymore.

China now represents a huge consumer market. The biggest market in the world for General Motors, iPhone and Apple is not their home country, the US, but mainland China. There are now some 750 million internet users in China, all demanding digital services, payments, information and social media. To meet these demands giant companies have emerged as world-class competitors. The secret of the global success of companies like Tencent, Alibaba and Baidu is not that they are particularly innovative, but that they have a huge customer base. Chinese are addicted to their smartphones. It's the new Chinese opium.

In online streaming, communications and payment systems China is outstripping the world. They have leapfrogged Western checkbooks and even credit cards. Most young Chinese wouldn't even know what a checkbook is! The advent of e-commerce is having a vast impact. Shopping malls in China are increasingly not selling goods because there simply isn't the demand there. Instead they are switching to selling services such as facials or whatever.

THE GOAL: TO DOMINATE THE VALUE CHAIN

There is another chain that is even more important than even the demand chain. It is the value chain. If you are successful in the value chain you own the brand, the intellectual property, the design and the industry standards. In this chain there's only one real superpower at present: the USA, followed by Japan and Germany and to some extent the UK. The real reason the US feels threatened by China is that China, having advanced from the supply chain in the 1990s to the demand chain currently, now aims to move into the value chain. The value chain represents the final frontier, the last battle. Who captures it will be the next dominant superpower.

A YOUNG OLD COUNTRY

China has traditionally been seen as an ancient civilization but among the major developed countries, China is the youngest. The current government and society in China dates only from 1949 when the Communist Party took over after having defeated the Kuomintang, the Nationalist Party, in the civil war. The United States likes to think of itself as a young country but it is, in fact, quite old. Its system of government dates back to 1786. China, being a young country, knows only one thing: that change is good.

China went through a traumatic experience, the Cultural Revolution. People look back not with nostalgia, but dread. They can only look forward. You see this by comparing Hong Kong with mainland China. Hong Kong is scared of change. They are proud of their legacy as a territory of the United Kingdom. Almost nothing can be changed in Hong Kong now. It is deadlocked. But in China, people talk constantly about change, as though it were a great blessing. They're going to make mistakes, sure, but they will get it right more often than wrong. They have lifted half a billion people out of poverty since 1979 and are rightly proud of this incredible achievement.

But stability and consistency are good too. It may go against the grain of liberal democratic thinking, but personally I believe that the recent controversial decision to remove the term limits for the Chinese president Xi Jinping is actually good for the investor. It provides an ingredient that is increasingly conspicuous by its absence in the world today, which is strong, stable and predictable leadership.

THE BEST OF FRENEMIES?

America's position is conflicted. It wants China to provide a big consumer market, but does not want China to move up the value chain. But these two developments are two sides of the same coin. How can China develop as a consumer market if it doesn't have the capacity to move up the value chain? I think the medium to long-term prospect is going to be one of friction and continuing conflict, as the US as the incumbent superpower tries to slow down or even obstruct the rise of a potential new superpower.

It's going to be difficult. The Chinese people won't be willing to compromise. Much of the discussion in the Chinese internet media these days is about how the country must become much more self-sufficient and not a hostage to vital components from the US. Kissinger was recently quoted that this period is like the period before World War I: incumbent superpower versus rising superpower. People are even envisaging scenarios like a new Cold War or a new technological war between the United States and China, with Europe caught somewhere in between. Maybe, hopefully, they are wrong.

Most problematic at the moment is the trade relationship between China and the United States. The media is hypnotised by America's $375 billion trade deficit with China. But you need to look at the trading relationship in total, not only the merchandise trade between two countries captured by customs figures. America has immense business interests in the form of subsidiaries in mainland China, not only iPhone but General Motors (GMC), Ford, Kentucky Fried Chicken, Starbucks, Caterpillar, and, of course, Boeing. A recent Deutsche Bank study calculated that, taking into account subsidiary sales, the deficit is less than 10% of the official figure. Another way of looking at things involves 'intermediate goods': the huge amounts of components from Japan, Korea, Taiwan and other countries that go into products sold by China to America. America's trade deficit with China would be roughly 35% lower than the official figure if you take this category into account. So, if you look at the overall picture, the trade relationship between the two countries is actually reasonably well-balanced.

I think the Trump administration is, in fact, well aware of this. And there's too much at stake for American companies which is why I'm confident that US business interests will push back against the tariffs. China, in its turn, needs a solution and is willing to bend over backwards to compromise.
There will probably be a truce or a temporary compromise of some sort, but not a permanent solution. Because the real fight isn't about trade, but the battle to dominate the value chain. That will be very difficult to resolve because the Chinese will not give way on that. They feel they have the right to be world-class. They don't intend to be laundry men forever.

COULD IT ALL GO WRONG?

Lastly, I want to turn to what could go wrong with my basically rosy scenario from an investment perspective. It is often pointed out that China's long-term demographics do not look good. Like many countries around the world, it faces an aging population. But the picture is not quite as grim as often thought because of China's education dividend. Each year the country is producing roughly 7.5 million college graduates - the pay-off from putting huge resources into education over the last ten years. In addition, Chinese workers on average now have nine years of schooling compared to eight in 2010. That extra year is already having a significant impact. Another factor offsetting the negative impact of an aging population is that China is now a global leader in the use of robotics in its factories.

Another problem often raised is China's potential debt crisis. China, undoubtedly, built up debt very quickly after 2008. In fact, many Chinese leaders think they did the world a great service after the financial crisis of 2008 when Wen Jiabao ordered a stimulus in the shape of massive reflation. Not a lot of people thank China for that. But it came at a cost. There has been an alarming increase in Chinese debt to the point where it is slightly over 270% of GDP. So why are people like me relatively relaxed about it and don't subscribe to the view of some of the well-known short sellers you see on CNBC or Bloomberg? Because, when you really analyse the situation, you'll find it's nowhere as bad as you might think.

For one thing debt is concentrated in state-owned enterprises (SOEs) and in local governments. And the lenders are state-owned banks. So in a way the Communist Party is lending to the Communist Party. And it is all domestic debt. China doesn't owe anything to foreign countries. In fact, on a net basis, China is a creditor to the rest of the world. China's credit position to the world is equivalent to 15% of GDP. More importantly, the area that should really interest investors is the main engine of the Chinese economy: the private sector. Over 70% of employment is now in the private sector. The banks have never favoured this sector, so it's not hugely leveraged. Capacity utilisation bottomed out in 2016 and has been improving since, so profits are actually doing well. Chinese debt looks superficially dangerous, but when you tunnel down, it looks much more manageable.

China also has one of the world's biggest savings pools, one that is largely trapped in the country because of government capital controls. That is changing, but for the time being the Chinese banks can take their funding for granted because the depositors have nowhere to put their money apart from bank deposits or real estate, where the opportunities incidentally are also quite tight: one apartment per family or person, depending on the city.

It amounts to financial repression. At the moment that is positive in that it helps China fund its debt mountain. But it's also negative in the longer run if the country is to become an advanced economy. In response President Xi Jinping has announced a program to gradually deregulate, open up markets and enhance the rule of law and enhance ownership rights in China. It may have the unintended effect of making Chinese debt more dangerous because people will have more ways

to part with their money and banks will not be able to take discounting for granted. But China has to do it. I have witnessed huge amounts of wasted capital in China: money being lent to people who can't use it properly because it's so abundant and so cheap; because it's their money and they have nowhere else to put it.

In the last couple of years, the priority has been cleaning up the financial sector before introducing more deregulation. There were a lot of irregular practices such as shadow banking and unauthorised wealth management products and other irregular financial practices in the Chinese capital markets. If they can successfully solve this, there is not much to stop China from achieving its goal of becoming a fully developed country by 2027.

But perhaps the biggest risk to China's development lies in changing attitudes in the US. The US seems to be turning its back on globalism and many of the Western democracies are also being swept along in the same wave of populist thinking. This could create a breakdown in the global economic system that we have enjoyed since the 1990s.

CRACKS IN THE MATERIALIST SURFACE?

Another challenge concerns social stability. In the West, political institutions, power transitions and the rule of law can be taken for granted. Not so in developing countries. China is a vast country with a difficult history and some serious emerging problems - the gap between rich and poor, the environment and the financial repression already mentioned. With access to the internet people are more aware than ever that they are not getting a good deal from the Chinese capital market while a few fat cats are doing very well indeed.

The Chinese man in the street feels he is breaking his back in the hope that, given the poor welfare system, he will get better housing, medical care and education for his kids. But it's really not a very satisfactory long-term situation. Social stability in China can be fragile in times of stress. It's a big country with lots of different groupings and the Chinese people, by nature a bit uncivil and rebellious, are not easy to manage. There is a lot to improve, in terms of civil behaviour. There's always this underlying, inescapable sense of tension that somehow, somewhere, something or other will break down and chaos will erupt.

People are scrambling for solutions. Some even long for the good old days of Chairman Mao, when the country was very poor, but very simple and when everyone was more or less the same. Another response in the major cities is a quiet, but powerful tide of interest in Christianity, Buddhism and other religions. I know it's surprising, but it's true, especially among young people. They sense that something is missing in the equation. More prosperity, yes, bigger cars, yes, more appliances, yes - but it is not enough. Spiritually the country is searching for a more meaningful answer. Do all societies go through that in this stage as they develop? Perhaps. And what are the investment implications? Unfortunately, I have to confess I do not have any answers to those questions.

KEYNOTE SPEECH DISCUSSION

THE COMMUNIST PARTY: DEAD HAND OR HELPING HAND?

'Will the government try to increase control over investors by means of technology?' asked a participant. 'On the face of it, the party is going to continue to fight to maintain control, Cheah replied. China now is only one of five Communist countries in the world although in fact it practices what amounts to a kind of state capitalism. Surveys show 80% support for President Xi Jinping. In everyday life people are surprisingly free. The individual Chinese man or woman enjoys more freedom today than at any time in the history of China, so long as they don't get involved in politics and oppose the Communist Party. That said, the party's official view is that the Western model is failing and that with big data and supercomputers and the internet, it will be possible for communism to be practiced more efficiently. But I don't know if they really believe in what they're saying. In ten years China will probably find a path to a more hybrid kind of system between Western liberal democracy and communism.'

THE FUTURE'S BRIGHT

'I believe that we are entering a golden period of opportunity,' stated Cheah, 'offering with the greatest opportunities ever seen in the history of the asset management industry in China. The same conditions that in the 1950s in the US allowed giant brands like Capital Group, Templeton and Fidelity to emerge now exist in China. China has no way forward except to follow deregulation, opening up its markets, enhancing the rule of law, protection of ownership rights and liberalization. Financial repression is on its last legs because otherwise the lid will come off and there will be huge capital flight from Chinese households looking for a better return.'

'There is evidence of the changes in my own company. In November, we were granted our first PFM licence, which means we are now able to fundraise under our own brand in China from institutional investors. Previously, we had to go through the Big Five banks which charge excessive fees. We have been told we may get a full asset management licence by 2020. We were also given a private equity licence in Shenzhen, using which we will open our first office in mainland China. Our biggest fund may soon get a Mutual Fund Recognition (MFR) licence allowing it to be sold directly to the Chinese public. I feel the new mood is a development of historical importance in human history. I live in a state of constant intellectual excitement as I travel the country. It's a turning point for the world, for better or worse.'

PUBLIC OR PRIVATE?

'The good news is that private enterprise is leaping ahead,' said Cheah. 'As recently as 2000 90% of listed Chinese companies were state-owned; now the figure is 50% and by 2020 likely to be 25%. These companies are under more pressure to perform. Their ROE is higher and efficiency greater. ln the old state-owned enterprises (SOEs) managements generally fail to maximise profits. In fact, I know of some Hong Kong fund managers who actually invest in SOEs because of their underutilised potential. Personally, I have no hang-up whether companies are state-owned or not except that we are value-oriented and SOEs tend to be cautious and play by the book.'

'Does the state still exert influence over non-SOEs?' asked a participant. 'It is a factor,' Cheah admitted, citing PetroChina which imports gas at prices guaranteed to lose money because the Chinese government signed agreements with source countries at levels favourable to them. In consequence PetroChina's shares underperformed. 'We find that same pattern across the board where loyalty to country is more important than the interests of individual shareholders. So you have to be flexible and prepared to put a discount on that factor.'

GOING GREEN?

Participants asked about opportunities to invest in companies working to protect China's environment – a pressing concern. 'Quite a number are popular in China and accessible to foreign investors,' said Cheah, 'such as the hydro-electricity company Yangtze Power which has a huge market cap. There are also smaller companies specialising in various environmentally friendly things like green energy or electric cars or the wind power guys. But they are so well-discovered that I focus on the more innovative companies that, for example, specialise in smart meters to monitor water consumption intelligently.'

WEIGHTING THE SCALE

Participants voiced concerns about corporate governance, especially minority discounts and variable voting rights. 'Governance has greatly improved,' replied Cheah. 'It was very bad in the 1990s, but is now actually above average for emerging markets, partly because penalties are very harsh. In fact, rather than dishonesty, I'm more worried about inefficiency and lack of competence.'

'As to variable voting rights, Hong Kong now licenses shares where the founder has five times more votes than other shareholders. I'm conflicted regarding this because apart from being a professional fund manager, I'm also on the Board of Hong Kong Exchange which recently turned down the opportunity for one of the biggest listings in the history of the world, refusing to let it have variable voting rights: Alibaba. In response Alibaba went off to New York in 2015.'

'It was a major blow. Alibaba's trading volume is equivalent to 15% of the entire trading volume of the Hong Kong Stock Exchange. Hong Kong also saw that Ant Financial and Xiaomi and several pre-profit, biotech and medical companies were about to flee to New York for listing. The compromise that has been agreed is that Hong Kong will allow variable voting rights, but only under strict criteria. You've got to have a certain size, history and track record and only individuals are allowed to have the more powerful voting rights. If that individual sells or dies or whatever, that right is extinguished. For now companies will not have superpower voting rights. It's a thorny issue on which I don't have a clear position myself.'

IN THE THROES OF CHANGE

'Chinese stocks fall into various categories,' he continued, 'some in Hong Kong and New York and a few in London and Singapore. On the Chinese mainland itself they're called A-shares. It's a huge market. Something like 3,500 companies listed on mainland China. It is the world's largest equity market after New York and it's very much a domestic market, dominated by retail Chinese investors. There are 100 million retail accounts and investors treat the market like a casino, a crazy short-term market where people buy small companies whose price can jump or fall very quickly.'

'Most also have substantial holdings in Chinese banks. Here, long-term value institutional investors like us enjoy certain advantages. The big Chinese banks like us on that account. These banks generally trade below book value and are not allowed to fail. So we've been buying these banks and made a lot of money recently when the banking sector was re-rated.'

'Out of the blue the Chinese government recently announced that they want companies to go back to China for listing in Shanghai or Shenzhen in the shape of Chinese Depositary Receipts (CDRs). Hong Kong felt under pressure because now, not only is New York a rival, but also potentially Shanghai. It's a very tense and complex game where everyone's afraid someone else is stealing their bread

and butter. At present most of our assets are listed in Hong Kong and we only use the Hong Kong Stock Exchange's Stock Connect Program to buy in China. However, we anticipate moving far more money to China in future. We have been told by the Chinese banks that give us mandates, whose typical size is $200 million to $500 million, that they want the investments to be in the shape of A-shares.'

'Chinese shares have not been easily accessible to foreign investors. Foreign ownership to this day is only 2%. However, MSCI is about to admit some of the more important A-shares into its Index, so making them better known internationally. Based on experience in Korea and Taiwan, Chinese domestic A-shares will continue to increase in numbers and importance and they could become an important part of our investment universe, especially if you are MSCI benchmark-conscious.'

A NEW CENTRE OF GRAVITY?

Dr Knight pointed out Tencent took a different route. As well as being traded in Hong Kong it has a very active American Depository Receipts (ADR) programme. 'Will the advent of the Chinese equivalent, the CDRs, detract from the ADR programme?' he asked. 'It's possible', Cheah thought but added: 'The Chinese requirement is not as threatening as at first thought because only companies with a minimum market cap of $100 billion will be invited to issue CDRs and only about five or six companies meet that criteria.'

'So is China poised to take the super power mantle from the US?' asked Dr Knight. Cheah thought not. 'Personally, I think China has to solve its own issues with its identity as a civilized country first. We are eagerly awaiting the next generation of Chinese who will be much more multi-dimensional, in terms of attitudes, not only respecting China, but also the rest of the world. A narrow approach focusing solely on China's interests is not fit to fill any vacuum left by the US. I favour continuing financial leadership by the US. It may not be perfect, but it's predictable.'