



# GLORIOUS RICHES: PROFITING FROM CHINA'S CAPITALIST REVOLUTION

By Jim Trippon

Nearly three decades ago Chinese premier Deng Xiaoping lit a fuse, touching off the biggest economic explosion of our time with four revolutionary words: "Getting rich is glorious!"

Deng made his unprecedented policy statement while initiating historic capitalist reforms, loosening central control of the Chinese economy and ending the government's absolute monopoly over the economy. At Deng's command the entire nation, still stagnating under a centrally planned Marxist economic system, jumped headlong into the capitalist race. Walk the streets of Shanghai or Beijing today and you will see a new China – a China that even Deng wouldn't recognize. As the editor-in-chief of the *China Stock Digest*, I and my staff in mainland China, Hong Kong, Taiwan and the United States are looking for the greatest investment opportunities in the world's fastest growing economy. During my most recent visit to China, I couldn't help marveling at the dramatic economic and social changes that continue to engulf every major city.

## TIMES ARE CHANGING

Many still think of China as a drab country filled with men in blue Mao suits riding their bicycles. Not any more. Now skyscrapers and cranes fill the skies, traffic is crowding the streets, and consumers are jamming into stores and restaurants. Along with progress comes some pain. Pollution, progress and rising energy prices signal China's entry into the league of major industrialized nations.

The new China is far from perfect, but it is a true economic miracle. It is already common knowledge that China's economy is the fastest growing in the world. Some experts claim the Chinese economy has been expanding at the phenomenal rate of approximately nine percent a year every year for the past two decades. Other economists claim that the Chinese economy has been growing even more aggressively: a growth rate of more than 11 percent a year! The shape of the world economy is changing so quickly that it will soon be unrecognizable to those who are not closely following the China story. If we extrapolate the new

picture of China's economic growth through 2006, we expect that China will end this year in the undisputed position as the world's fourth largest economy. Surpassing the United Kingdom in size, China is on target to challenge the remaining contenders: Germany, Japan and the U.S.

True, China still has a long way to go before it eclipses the United States' economy, which had a gross domestic product (GDP) of \$11.7 trillion last year. But the day is coming. There are now predictions that China will overtake the U.S. in 2035, five years earlier than previously expected. The World Bank has another way of measuring economic scale, the "PPP" method: purchasing power parity. In terms of total purchasing power, the Chinese economy is now the second largest on the planet, once again following only the United States.

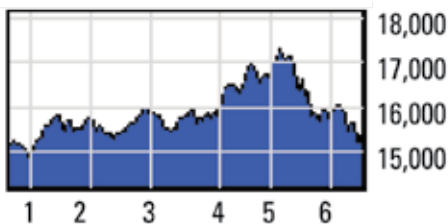
## WHY SHOULD U.S. INVESTORS CARE?

What does all this mean to investors? Cynics and pessimists will point out that China's economic output per person is little more than \$1,700. In terms of income per person, China was ranked 134<sup>th</sup> in the world in 2003, according to the World Bank. This is a classic question of the pessimist seeing the glass as half empty and the optimist seeing the glass as half full. We see the glass as half full, not so much because we are optimists, but because we are investors. We care about participating in a major growth event. We also care about diversifying our holdings at a time when the U.S. economy is feeling the strain of high deficits, trade imbalances, currency devaluation and inflation. Despite its phenomenal growth, the Chinese economy has avoided inflationary eruptions and major investment bubbles. But a word of caution is in order: Investing in China means accepting volatility as the price of participation in an unprecedented global growth story.

## OVERHEATING GROWTH?

Is China growing too quickly? The Chinese Finance Ministry says inflation is under control, but it may opt for a second round of interest rate increases this year in order to bring growth under control. We see this as a sign of responsibility from a government

**FIGURE 1:** Hang Seng Index 33 (12/19/2005 - 6/16/2006)



Source: Hong Kong Exchanges and Clearing Limited

that is under enormous pressure to encourage growth with all possible speed. In its most recent and ambitious five-year plan, the government set a goal to lift hundreds of millions of citizens who remain in mostly rural poverty to a decent standard of living. Of course, throwing the gates open to unlimited growth could invite severe inflation. Part of the Chinese economic miracle is the nation's ability to maintain very rapid growth for two decades without falling victim to hyperinflation.

Although many still regard China as a lumbering, bureaucratic giant, it is truly a nation being transformed from within. Recently the International Institute for Management Development based in Lausanne, Switzerland issued the latest *World Competitiveness Yearbook*. The surprise of the year was China. Last year, China ranked 31<sup>st</sup> in competitiveness among the largest 60 economies in the world. This year, the nation's economy has risen to number 19, a remarkable achievement for a country still throwing off the legacy of a centrally planned, Marxist economic model. Government efficiency has been ranked, amazingly, as 17<sup>th</sup> among world economies. This puts China far ahead of Korea, which ranked 38<sup>th</sup>.

Macroeconomic regulation (such as government controls to prevent severe inflation) has been credited with building a solid basis for a strong, efficient economy. But the scrapping of excessive government control has been equally important to economic efficiency. Thousands of useless and counterproductive rules left over from the days of central planning have been jettisoned for good. The Chinese economy still faces challenges. It must shift from a growth model driven by very high investment levels to a demand-driven model. In other words, the Chinese must become bigger consumers of their own products. They must learn to spend and borrow wisely rather than socking away trillions in unproductive bank deposits.

Unfortunately, rapid growth often goes hand-in-hand with volatility. A number of indicators show that as a group Chinese stocks gave up many of their gains from January of this year during the past month. See *Figure 1*. We recommend only ADRs (American Depositary Receipts) as part of a conservative, value oriented strategy. More about value ADRs in a moment.

## CHINA'S FOUR STOCK EXCHANGES

Chinese stock markets are composed of four unique stock exchanges. They are the Hong Kong, Shanghai, Shenzhen and Taipei markets, and they are run under three different market systems. The stock exchanges in Shanghai and Shenzhen are run by the People's Republic of China (PRC), which is still learning its way in the financial regulatory area. By contrast, Hong Kong's stock exchange operates much like the London Stock Exchange. The Taipei Stock Exchange is run according to Taiwanese rules, which are also similar but not identical to the regulations in London and New York. Some in Taiwan do not consider themselves to be part of China. However, just like those in Hong Kong who felt that way 30 years ago, a change is in the wind for Taiwan.

Therefore, one of the issues investors have to consider with regard to risk is that Hong Kong and Taipei have a history of financial regulations and legal systems that are fairly well established and reliable. The Chinese exchanges in Shanghai and Shenzhen are operating in a country that has explosive economic growth, but their regulatory infrastructure hasn't yet caught up. That's true in any emerging market, and it does create an added level of risk in the PRC. To be specific, issues such as intellectual property protection, financial disclosure, corporate governance, and the issues about the amount of information released to a potential investor all create a higher level of risk dealing in the Chinese markets than you would have in a more transparent or more regulated market such as New York or London.

## LEARN THE LINGO

In addition, the Chinese market system is still evolving and emerging from a complex financial and political history. There are a confusing variety of shares to be understood. There are A, B and C shares traded on the Shanghai and Shenzhen exchanges. There are "Red Chips." H, N and L shares traded in New York, Hong Kong and London. Most of these shares we deliberately avoid. When dealing with companies from the People's Republic of China and Taiwan, we want to focus exclusively on companies that are listed on the New York Stock Exchange as ADRs. There's a very important reason. In order to qualify as an ADR, foreign companies must step up to the stringent disclosure requirements of the NYSE and NASDAQ in order to maintain their listings. We feel strongly that sticking with companies that meet these standards gives us an essential layer of protection against investment risk. Hong Kong and Taipei have much more advanced regulatory systems, and we feel we can put much more reliance on the information released by companies whose stocks trade on these exchanges. But, again, we stick to ADRs

Also important, we want to invest in companies that furnish investors with real-time trading data and multiple sources of news about current corporate events. It is our opinion at the *China Stock Digest* that companies that are traded on the NYSE and NASDAQ are much more likely to meet this standard. Fundamental struc-

tural change and rigorous policing are essential to restoring confidence in the unruly Shanghai and Shenzhen exchanges. Visit China's stock exchanges and you will see gleaming towers with gargantuan trading floors. They give a casual visitor the impression of a modern, highly advanced system. But internal exchanges are far from meeting that standard. The rules allowing greater foreign investment within Chinese exchanges are simply not enough. Changes to allow the beginnings of options and derivative trading still don't allow investors to manage risk efficiently.

## BE WARY

We are sometimes asked why the *China Stock Digest* isn't more active in Chinese Internet stocks. After all, some investment gurus are touting gains that seem almost miraculous, supposedly brought about by investments in China's Internet sector.

We have researched the Internet sector extensively. We are aware that there are more than 100 million Internet users in China, and the sector is expected to bring in about \$2 billion in revenues this year. But by Chinese standards, these are small numbers. Our analysis indicates that the sector is too immature and unstable to warrant the inherent risks. The fantastic claims made by some Chinese Internet stock promoters do not stand up to serious scrutiny.

The key is to buy good companies. We recommend companies that will participate in the best of the Chinese growth story without exposing investors to undue risk. Many blue-chip Chinese companies pay regular and reliable dividends. A solid dividend—and some good companies pay as much as seven percent—helps take the sting out of market volatility. In the long run, we believe the Chinese big cap/value market will rebound above worldwide indexes because of the continued growth of internal and external consumer markets. The good news for China investors is that China has not suffered the severe bear markets that other developing nations have endured. In a recent ranking of stock price drops country-by-country, China stood among the best performing economies including the U.S., Canada and the U.K.

## THE CURRENCY PEG

Compared to China, emerging market stars like India, Russia and Kuwait have taken a back seat. They are deep in "bear" territory while China has overcome the market setbacks with little more than a scratch. There are profound political issues swirling around China's export surplus. Most Chinese trading partners agree that the national currency, the yuan is being kept artificially low. The low valuation of the Chinese currency makes exports more attractive to foreign buyers, and some say that gives China an unfair advantage. The most radical voices in the U.S. Congress are demanding tariffs of 27.5 percent on all goods imported from China.

Whatever the merits of their arguments might be, any such action is highly unlikely. The consequences would be disastrous

on both sides of the planet. If punitive tariffs were imposed, Chinese exports would be slashed. China's ability to purchase U.S. Treasury bonds and its ability to sustain America's indebtedness would be crippled. The consequences for the American economy would be as severe for the United States as they would for China. There may be a lot of bluster coming out of Washington lately, but few politicians would risk such a potentially suicidal step. As well as being a key trading partner, China is becoming America's banker, holding more than \$800 billion in U.S. debt.

Although China has emerged as a \$2 trillion economy, it is still managed to a large degree by the state. That's why we pay such close attention to the words of the Chinese government. Finding companies that will succeed in China means much more than looking over a balance sheet. Investors need to know the political climate that will affect the companies they have a stake in. As rigid and controlling as the Chinese state may appear to outsiders, we believe we see the government's true face. We know the problems away from the tourist showpiece cities, and we know that much of China remains desperately poor. China must continue on the road of aggressive expansion. It has no other choice. Sometimes the government may be too aggressive when it strips farmers of their land and rights in its drive to build essential projects. But China has no options except mega growth.

## RIDE THE SEA CHANGE

Because China has a population of 1.3 billion people, we have not yet begun to explore its full potential. The world is entering a new phase of economic development that will be neither simple nor brief. We have no doubt that China will emerge as the world's largest economy. We know it cannot achieve this goal without ongoing capitalist reform and investment. We believe that nothing helps economies grow like enlightened capitalism. And, nothing returns profits to investors like well-informed capitalism. The most populous country in the world is in transition from communism to free market capitalism. And we are committed to building a mutually profitable relationship. Join us in September as we explore China's industries and evaluate their investment potential. ■

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*Jim Trippon, editor of the **China Stock Digest**, is one of America's foremost authorities on China investing. Trippon and his staff in mainland China, Hong Kong, Taiwan and the United States research investment opportunities in China's publicly traded equities. Trippon is the author of **How Millionaires Stay Rich Forever** and is the personal financial advisor to some of America's wealthiest families. For more information visit [www.chinastockdigest.com](http://www.chinastockdigest.com).*



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