Principal® Global Equities

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From Silk Roads to Stock Markets

Perspectives on Stock Investing

Perhaps not since the Tang Dynasty (618 – 907) has the world at large been so interested in or connected to China. Then, there was the Silk Road, which connected East to West through an unprecedented network of trade routes. Now, a decade after China's accession to the World Trade Organization, a similar thread of global commerce binds China to most parts of the world. To see the effects of the growing importance of China, one needs look no further than the weekly periodical *The Economist*. In January 2012, the newspaper added a section devoted exclusively to China, marking the first time since 1942 —when it added the United States—that it's singled out a specific country for detailed ongoing coverage. Initially, interest in China revolved around labor-cost advantages and the benefits to its export market. Now, China is increasingly delving into more sophisticated manufacturing techniques and developing global brands. China also has a seemingly unending appetite for basic minerals, materials, and food products, which makes it an enticing destination for producers of such items.

China is a compelling opportunity for financial investors because the environment for investment has improved drastically over the last few decades. Aspects like infrastructure, market-access mechanisms, and investment capital are all in place. As the governmental controls on China's economy are gradually liberalized through a more open economic architecture, the impact of policy influences on the Chinese economy and stock markets should wane in coming years. This will help bring tremendous focus to company-specific factors, something that can dramatically increase the potential for investment opportunities. To that effect, the equity markets of Hong Kong and mainland China represent a tantalizing, and perhaps unavoidable, opportunity for investors.

As was the case when traders plied the Silk Road, this is an opportunity that requires strategy. Rather than just picking stocks and putting your money to work, investment in China requires close consideration of the various options for gaining exposure. Investors can directly access China through the mainland exchanges; however, this requires access to a manager with the appropriate licensing. Hong Kong has been the traditional gateway for non-Chinese investors to gain access to Chinese equities. Investors can also make use of China's vast economic connections with the rest of the world to indirectly access China through diversified emerging markets and broader global equity strategies. It is important to understand each of these strategies and how they fit into the wider context of China's economic growth.

MARCH 2012

Direct China Exposure

The equities markets in China have grown immensely as the country has listed its massive state-owned enterprises. A list of the top 10 companies in the world by market capitalization will show that China now regularly grabs three or four of the top spots, a far cry from the top-10 composition just a decade ago. Shanghai, the more popular of the two mainland exchanges, tends to be heavy in large-cap names and contains some of the biggest banking, energy, and industrial companies by market capitalization. The Shenzhen Stock Exchange is smaller, but more diversified, with more constituents that cater to Chinese consumption and an industrial investment theme, e.g., companies in the consumer discretionary, industrial machinery, and information technology sectors. For most non-Chinese investors, access to the yuan-denominated shares of the Shanghai and Shenzen markets requires status as a Qualified Foreign Institutional Investor (QFII), or access to such a QFII manager. QFII strategies are somewhat limited in number and constrained by a quota system, but are an attractive way to gain direct access to China and exposure to the local currency.

The Hong Kong equity market, unencumbered by QFII quotas, presents another alternative for direct exposure to China. With one of the most advanced stock exchanges in the world and a tax regime that is very supportive of cross-border portfolio investments, Hong Kong has been the conventional market through which investors have accessed China. Hong Kong's status as the gateway to China is greatly bolstered by an ever-increasing roster of mainland companies that are keen to list on its exchange. Hong Kong allows these firms to attract the vast sums of global capital awaiting Chinese investment opportunities – from large state-owned giants to small, privately owned, niche companies engaged in the critical sectors of China's industrialization. Today, the majority of the market capitalization of equities listed in Hong Kong comprises mainland companies or other companies doing substantial business in the mainland. This gives investors a substantial range of investments to access through Hong Kong. Historically, the rivers of global capital invariably flowed into New York or London, but in recent years, there has been a prominent new tributary to Hong Kong. Current efforts by regulators to set up an offshore yuan market in Hong Kong will increase that flow.

Indirect China Exposure

Investors can also gain access to China through a diversified emerging market strategy or a broader global equity strategy. Investing this way can combine the benefits of China's economic growth with global diversification. There are really two stories with the indirect China strategies; one is an attempt to access the growth of the domestic consumption markets and the other is an effort to tap into the Chinese engine of growth that services the external global markets.

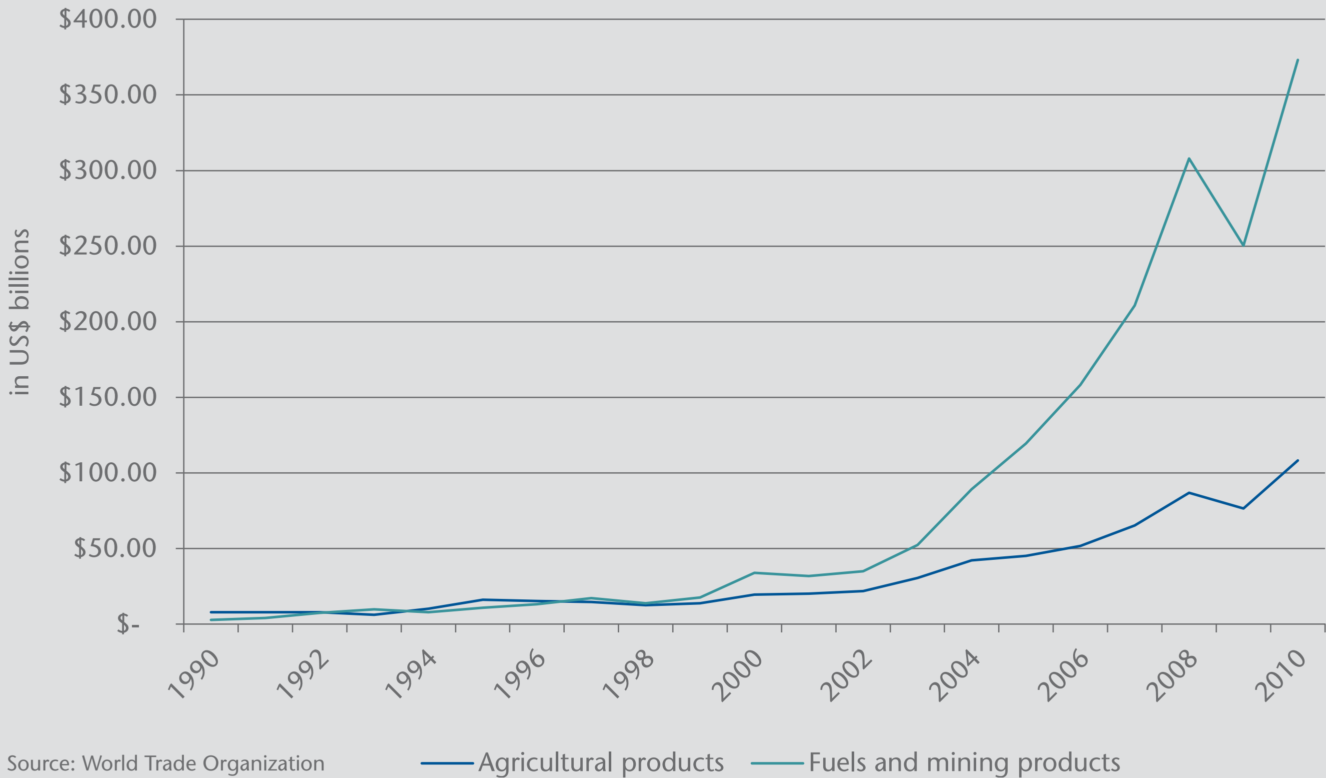
China Equity Timeline

Year	Event
1866	13 companies appear in a Shanghai newspaper, marking the first public listing of shares in China
1891	The Shanghai Sharebrokers Association (SSA) is established
	Association of Stockbrokers of Hong Kong (ASHK) founded, marking the first formal Hong Kong exchange
1904	SSA officially renamed Shanghai Stock Exchange
1914	ASHK renamed Hong Kong Stock Exchange
1941	World War Two halts trading on Shanghai Stock exchange – it will never reopen as a foreign share brokers association
1980	Stock Exchange of Hong Kong incorporated to consolidate several exchanges
1986	Stock Exchange of Hong Kong commences operation
1990	Present iteration of the Shanghai Stock Exchange is established and re-opened
	Shenzhen Stock Exchange opens
1997	Britain cedes control of Hong Kong back to China
2002	China launches QFII program to allow licensed non-Chinese investors to trade in yuan dominated A shares.
2003	First QFII license granted
2008	Last major round of QFII approvals

Diversified Emerging Markets

The connections between China and the world's emerging markets are growing exponentially. China is beset with an imbalance between the tremendous size of its population and the deficiencies in its resource base. An emerging markets strategy is centered largely on the emerging world's ability to feed China's tremendous appetite for commodities such as oil, coal, iron ore, copper, soybeans, and meat as shown in **Exhibit 1**.

China Commodity Growth



Source: World Trade Organization

Brazil is a good market to gain indirect exposure to China because they export so much of their iron ore and soybeans to China. A water shortage in the northern areas of China that traditionally produced soybeans has resulted in decreasing domestic supply and China now sits as the world's largest importer of soybeans. Brazil is ready to meet that need. Similarly, China is the largest importer of iron ore and buys over 20 million tons of it from Brazil every month. It is, therefore, no surprise that many treat Brazil as an option on Chinese industrial growth.

On an incremental basis, China has also become the world's leading importer of crude oil. The three state-owned oil companies are seeking more and more overseas oil-development projects; this holds positive consequences for oil-rich markets in Latin America and the Middle East.

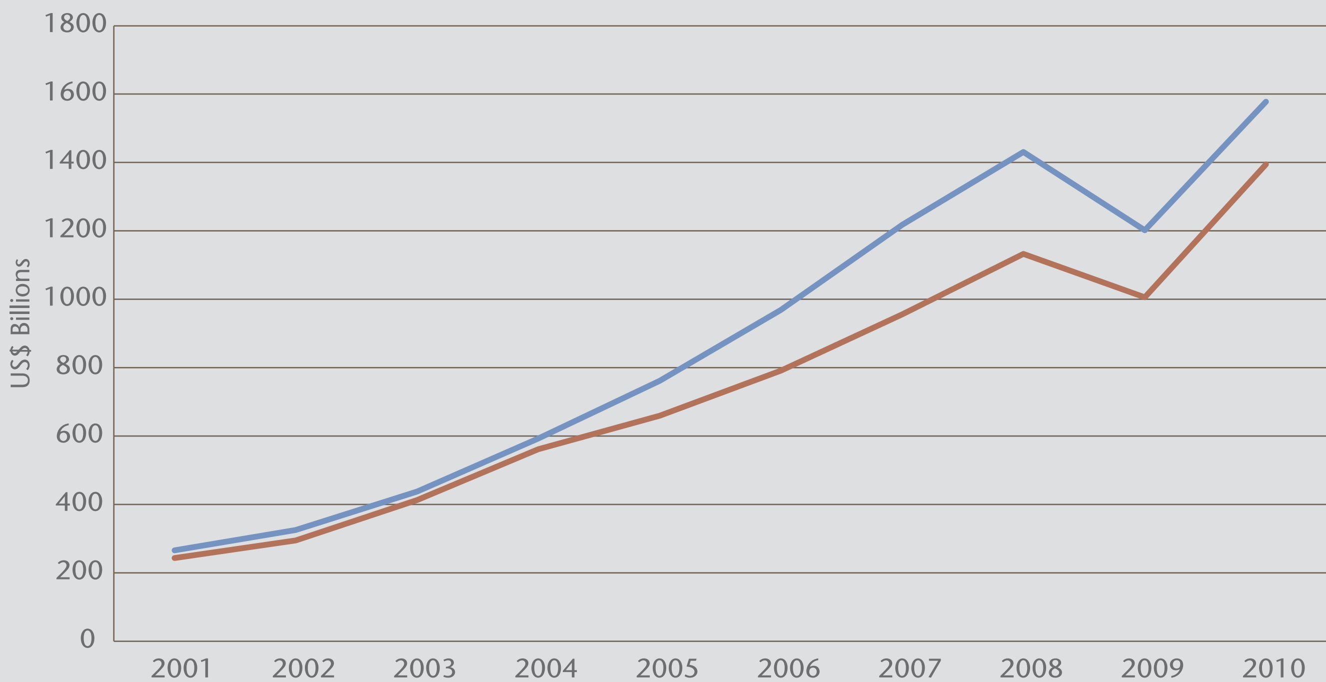
Over the last decade, markets supplying goods to the American economy were the biggest beneficiaries of the U.S. consumption boom. In much the same way, as China consumes more, it is bound to be very positive for global companies that cater to its consumption needs. As China remodels itself into a consumption-driven economy, the biggest beneficiaries of that change will be the low-cost emerging market countries that can provide these consumption goods. Asian emerging markets stand in a particularly good position to benefit from this trend. Trade between China and the rest of Asia has grown significantly over the past several years. For example, Taiwan signed a landmark trade deal with Beijing in August of 2010. China is also in discussions to start a three-way trade agreement with Japan and South Korea, and a separate two-way agreement with South Korea alone.

Much of the focus in this type of China strategy is on the larger developing markets; however, there is an increasing place for the smaller, more "emerging" of the emerging markets, often called frontier markets. For a China-centric investment strategy, these high-potential markets fall into a couple of categories: either Asian satellite nations where China is a dominant trading partner, or Latin American and African nations that supply China with commodities. Frontier markets can have their challenges (e.g., reduced liquidity and lower transparency); however, their lower correlation with developed markets, and even other emerging markets, provides a possible source of greater diversification as well as indirect exposure to China.

Broader Global Equity Strategy

A diversified emerging market strategy brings exposure to China with increased diversification over direct investment, but this diversification could be enhanced further through a strategy that captures exposure to China through a broader global equity mandate. Rather than relying heavily on imports to China, a global equity strategy can be more balanced, playing between imports and China's exports to the developed markets as shown in **Exhibit 2**. Exports from China hold increasing sway over the economies of developed markets. Back in 2010, Germany saw stunning GDP growth of 9%, due in great part to massive demand for cars and machinery items from China. Over 35% of the revenues of S&P 500 companies are believed to come from non-U.S. sources, and a significantly growing part of that is China. That number is even larger for European companies, who export goods and materials to China in vast quantities. Some of these features of the Chinese growth juggernaut can be captured very well through a broader global strategy.

China's Trade with The World 2001 - 2010 (US$ billion)



Source: U.S.-China Business Council,
PRC National Bureau of Statistics

Risks to a China Strategy

Regardless of the particular strategy, there are some risks to any China-centric equity investments. China has seen and will probably continue to see a great deal of "hot" money flowing into the country. The result could be a preponderance of asset bubbles, already seen somewhat in Chinese property markets.

There is also a demographic risk in China, which is perhaps 15 years remote. With population controls still in place, China could lose its demographic advantage as its relatively young population ages. Such a shift also has the possibility to alter the consumption and investment patterns in China, potentially heralding a move to more defensive items when there become fewer young people to support the aging population.

This article merely scratches the surface of the possibilities in gaining equity exposure to China. For those looking for further assistance, Principal Global Investors stands ready to help. We have extensive capabilities in Hong Kong and China equities, emerging market, Asian, and global equity strategies. Our core, bottom-up investment process focuses on the early identification of fundamental change, and we pride ourselves on our purposeful integration of thorough fundamental research and sophisticated quantitative ranking tools.

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