CONCRETE ASSETS: Shanghai’s new skyline on the Huangpu River stands testament to the astonishing growth of China.
The rapidly growing Chinese middle class is fueling the expansion of local pension funds and domestic consumer spending. Investors are taking note. By John Butcher

China goes into overdrive

China is the frontier of choice nowadays for savvy hedge fund managers. The most populous nation in the world, its economy has experienced dramatic expansion in recent years. That has attracted a growing crowd of alternative investors, and the boom shows no real sign of abating.

The Chinese economic story is staggering. China’s gross domestic product is rising at around 10% annually, compared to 3% in the US. Consumer spending is rising by 13%. The country’s middle class is now estimated to number between 150m and 200m people and is expected to double in size in the next five years. The rise of China has been, and continues to be, phenomenal. In fact it has been described as the fastest change in human history.

The recent sharp drop in Chinese stock markets – the Shanghai market fell nearly 9% last month – triggered a global sell off in equities, commodities and oil amid fears that a slowdown in China’s economy would follow.

According to Simon Coxeter, founder of AsiaSource Capital, the incident was nothing for hedge fund managers to be concerned about. In fact it provided an opportunity for them to differentiate themselves from mutual funds.

“There was a lot of ‘noise’ following the sharp correction in February, which was understandable after the largest single-day fall in ten years,” Coxeter says. “Rumours ranged from a potential capital gains tax on equities to further government austerity measures. In our view, the sharp intra-day moves in February demonstrated the power of relatively unsophisticated investors on the market pricing mechanism. This is likely to remain a volatile market over the next few years, but as new hedging tools become available, savvy hedge fund managers may well thrive.”

“Most hedge fund money is invested in China through securities listed in Hong Kong. The correction in Hong Kong-listed China stocks through January and February actually helped China-focused hedge funds differentiate themselves from mutual fund products. The flip-side is that some managers charging hedge fund fees, but delivering little more than mutual fund-style risk/return characteristics may start to look vulnerable – all part of a healthy process, in our view.”

Mark Whistler, who writes and conducts research for The Oxford Club and Mt Vernon Research, is the author of the recently released book Trading Pairs and one of the two creators of PairsTrader.com. He adds: “It’s hard to call a 9% dip a ‘crash’, if we stop to consider that the Shanghai composite index rallied 127% in 2006 alone. To label the recent decline anything more than a ‘pullback’ would be like seeing one brick fall off the roof of a new house and then run away screaming that the whole thing is coming down.”

The Chinese ‘opening up’ is letting in global financial players and allowing greater access to opportunities for hedge fund managers.

The one barrier has been Chinese bureaucracy – the state machine has traditionally moved slowly where financial markets are concerned. But China’s ‘opening up’ is gradually letting in global financial players and allowing greater access to untapped opportunities for hedge fund managers. The Chinese economic story is staggering. China’s gross domestic product is rising at around 10% annually, compared to 3% in the US. Consumer spending is rising by 13%. The country’s middle class is now estimated to number between 150m and 200m people and is expected to double in size in the next five years. The rise of China has been, and continues to be, phenomenal. In fact it has been described as the fastest change in human history.

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The long-term prospects for hedge funds in China certainly look promising. It is a nation just entering territory that has been well-trodden in the West, such as private pension funds. As the Chinese middle class grows, the potential for private pension funds is enormous. They will no doubt take the same route as in the US and Europe, which would involve increasing allocations to alternative investment over a period of time. Like most developments in China, that process is likely to be accelerated into overdrive compared to the West, although opportunities for hedge funds to capitalise are still some way off, according to Coxeter.

“Reform of the pension fund industry will have longer-term implications for capital allocation to alternatives, but there is unlikely to be a significant impact over the next few years,” he says.

China’s rising middle class will also mean rising consumer spending across all levels of goods, from luxuries to everyday items. In the wealthy Eastern coast cities of China, including Shanghai and Hangzhou, visitors might be surprised to see rows of dealerships selling the world’s most exclusive and expensive cars.

Rising domestic demand is already an important play for hedge fund managers targeting China. According to Alberto Bassetto, of Jayhawk Capital, there are “specific opportunities in health care as well as stocks that benefit from rising discretionary incomes.”

Living standards set to rise

The China Mantou Fund, managed by Pacific Sun Investment Management, is buying into food and agriculture, retail, and transport stocks. “Rising disposable income levels and international trade are major themes for the long side,” says portfolio manager Andy Mantel.

At its annual legislative meeting in March the Chinese government made commitments to raise standards of living across the nation – particularly in rural areas – that it hopes will raise domestic consumption. These changes spell further opportunities for hedge fund managers looking to invest in companies that are geared towards domestic consumption.

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EMERGING MARKETS

Many Chinese got their notion of a hedge fund manager from Le Chiffre, the Casino Royal bad guy, who brings down companies with terrorism.

EMERGING MARKETS

grow old,” says Li Li, a reporter for the Beijing Review who covered the recent government meetings.

The Chinese government also made other commitments that could produce opportunities for hedge funds. One was a tax incentive for companies involved in building China’s infrastructure. The other was a tax incentive aimed at levelling the playing field for domestic and foreign companies and attracting high-technology businesses. The Enterprise Income Tax Law ends preferential treatment for foreign companies that has lasted two decades. Foreign-owned firms in some special economic zones currently enjoy a lower rate of income tax than Chinese ones – 24% or 15% compared to 33% – as an incentive to attract them to China. Some domestic low-profit enterprises also attract lower taxes of 18% or 24%.

The government plans to end the foreign company tax incentive, while companies involved in hi-tech industries will continue to enjoy a lower tax rate of 15%, and small low-profit companies will be taxed at 20%. These tax changes should make Chinese companies and high-tech firms in China more attractive.

The bigger picture is that they mark steps by China to move away from cheap labour and cheap goods to becoming a producer of high-quality innovative products. In other words, China wants to be like the West. This change of path could be worth watching for the future.

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“Many of the stocks that we hold pay very low taxes and this will be the status quo for the short to medium term because of grace periods that the government will allow. Overall we believe the new tax laws will be positive,” he says. "But this is part of a strategy to move up the curve into higher value-added production," he adds.

The long book of the China Mantou Fund, run by Pacific Sun Investment Management, holds private sector stocks in nimble companies run by entrepreneurs rather than stodgy state sector stocks, according to the portfolio manager Andy Mantel.

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Another significant announcement made at the Chinese government’s legislative meeting was the formation of a special body to manage its more than $1tn in foreign currency reserves. Currently those reserves are invested in safe havens, much in low-yield US bonds. That could change with the formation of the new management body, which is likely to look for more efficient uses for much of it, according to reports.

China’s investment in low-yield US bonds “has served to keep US interest rates low and allow American consumers to borrow at cheap rates and buy a mountain of Chinese products,” notes John Mauldin, president of Millennium Wave Advisors.

A shift in China’s investment strategy, particularly a reduction in the purchase of Treasury bonds, would affect the US, which relies on China to help finance its multibillion-dollar budget deficits, and perhaps eventually push up US interest rates. It makes sense that China should try to get a better return on its assets than US Treasuries, and there are precedents. Singapore invests its reserves in stocks and bonds, as well as the outright purchase of a wide variety of businesses. Norway has $289bn in stocks and bonds under management in its Government Pension Fund, and the fund can invest up to 50% of its assets on the international stock market.

“What if China takes half its growth in foreign reserves and puts it to work? You could be talking $1tn by the end of the next decade. That is a massive amount of investment,” says Mauldin.

Commenting on the launch of the new body to oversee the country’s foreign currency reserves, China’s finance minister Jin Renqing said: “We can achieve more profit from the investments,” a remark that suggests higher-risk investments are likely. One potential route for the money could be higher-producing assets than US or euro bonds. “China may be about to start down the path to becoming the world’s largest private-equity hedge fund,” says Mauldin.

Some Chinese economists and media reports have suggested that China might stockpile oil and other raw materials or finance social programmes in order to encourage Chinese consumers to spend more and reduce dependence on exports. This again could see a boost to companies targeting the Chinese consumer, and provide a helping hand to domestic firms.

The vastness of China and the speed of its development means that whatever it does will have an effect across the world. The country is an enticing prospect for entrepreneurs and investors, but is not...
China may be about to become the world’s largest private equity hedge fund

John Mauldin, president, Millennium Wave Advisors

always the easiest market to crack. Hedge funds cannot operate as freely in China as they can in Europe or the Americas, for example. There is a heavy level of bureaucracy that has forced most hedge funds to operate from outside the country.

According to research conducted by Eurekahedge last year, the main decision-making centre for Asian hedge funds was the UK, followed by Hong Kong/China, the US, Australia, Singapore and then Japan. For managers setting up offices in Asia, Hong Kong or Singapore are the primary locations outside of Japan. Both have robust legal and regulatory systems, but their regulatory authorities have adopted different approaches to hedge fund supervision. In Singapore, hedge funds generally fall under the Exempt Fund Manager Scheme if they meet certain basic requirements (for example, at least 80% of AUM must be from non-Singaporeans), which means they can avoid a lengthy licensing procedure.

Conversely, managers in Hong Kong must obtain a license, which can take up to six months to process. Singapore is becoming increasingly popular with start-ups because of the low cost and manager-friendly regulations.

Mainland China is a novice in the hedge fund world, and it will take time for investors to get past the funds’ bad-boy reputation. For the Chinese, who flocked to the cinema recently to watch the first James Bond movie ever aired on the Chinese mainland, their impression of a hedge fund manager could be Le Chiffre, the Casino Royale bad-guy who shorted companies and then brings them down through acts of terrorism.

Reports that some China-focused managers recently engaged in unlicensed trading activities in the Chinese stock market did nothing to enhance the chances of a warm welcome by the Chinese government.

Company governance and culture is also a barrier, according to Bassetto. “Many companies, unlike in the US, do not have investor relations personnel and are not overly friendly to investors,” he says.

“They do not do this maliciously. In fact, just the opposite is true. They love to talk to investors willing to put in the effort to undertake deep due diligence. But, unlike many Western companies, they are not promotional – no press releases or earnings conference calls – because they are focused on their operations and generating profits. So while they are somewhat harder to analyse – especially given the lack of sell side investment research – this creates the opportunity to uncover gems.”

He adds: “Perhaps the biggest regulatory constraints are the lack of open access to the A-share market and restrictions on shorting mainland shares.”

Openings in China’s markets

But while the Chinese mainland remains a more difficult arena to operate in than elsewhere, there are signs of increasing openness. Index shorting was introduced recently to the domestic exchanges, individual stock shorting has been given regulatory approval, and stock lending should gather momentum over the coming years. Announcements by the China Securities Regulatory Commission recently have been positive toward the introduction of interest rate and index futures, says Coxeter. “Foreign investment banks will have increasing scope to offer derivative tools to investors, which should be positive for hedge funds,” he adds.

Jayhawk has not faced any issue on the short side with borrowing stocks, according to Bassetto, and liquidity is improving. “With all developing markets, liquidity can be a concern, but the China markets are getting deeper and broader every day,” he says.

As the markets grow deeper, so too does the Chinese hedge fund industry. There were more than 60 Greater China-focused funds, managing around $5.5bn in assets as of the end of last year, according to Rajeev Baddepudi, an analyst at Eurekahedge. “Based on fund size growth seen over the past five years and the current pace of growth of the underlying market, we expect the industry to at least double in size by 2010,” he says.

According to Whistler and many other observers, the best is yet to come. “I smell some incredible new opportunities approaching, especially for those funds that have diligently worked to set up shop in this Communist country,” he says.