Partisan Strategie Fonds (CHF)

Strategy Meeting 4th Quarter 2015:

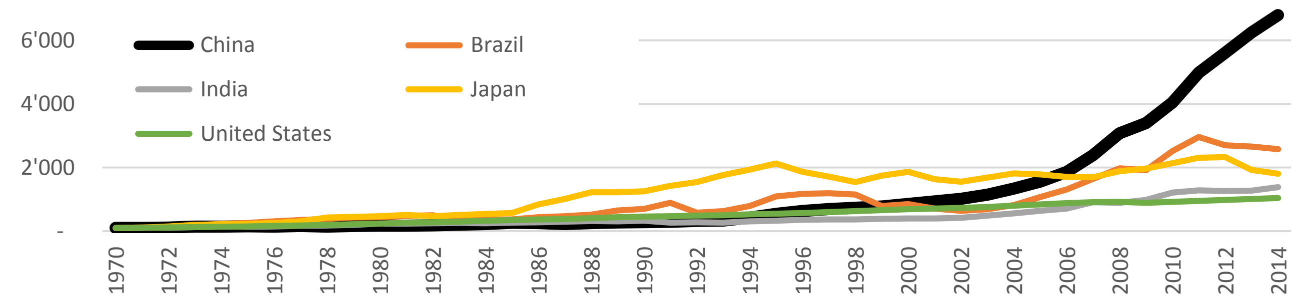
China

China has become the second largest economy after the US. A discussion with guests from the consulting company *China Intelligence*, confirmed our optimistic expectations for the further development of China.

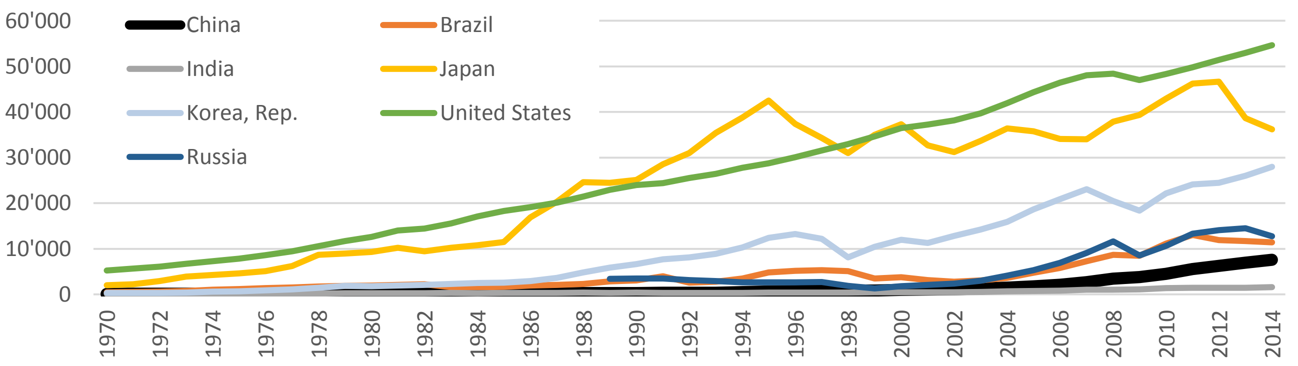
Nevertheless, we do not increase our equity exposure to China in the context of our long-term investment strategy for the time being. Firstly, the development of China's stock market is still in its infancy. Secondly, our exposure to European and American companies brings about a significant participation, as they have increased business activities in China to a substantial amount. Below are some interesting aspects of our investment meeting in December.

Economic Development since 1970

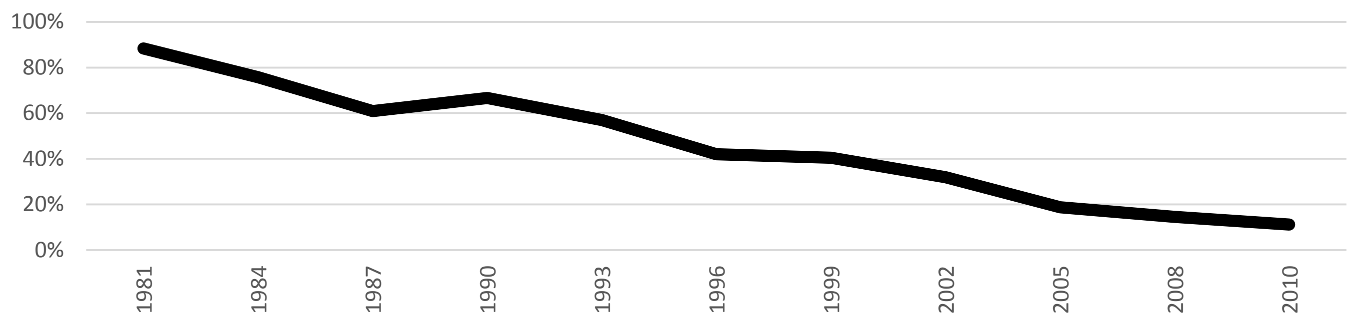
Until the early 80s, China was under Mao Zedong an extremely poor and isolated country. Since then, gradual reforms and economic opening has brought high economic growth and a strong decrease in poverty. The following charts show this impressively.



GDP per capita: Relative development (1970 = 100, source: Worldbank)



GDP per Capita: Absolute in USD, inflation adjusted (source: Worldbank)



Proportion of population in extreme poverty (income smaller then $1.90 per day, 2011 PPP, source: Worldbank)

Outlook

Especially in the west, the view is often expressed, China's growth is not sustainable. In particular, the non-democratic framework is a hindrance to the development in the long run. Others argue China's state capitalism could remain a successful model, necessary reforms provided. Due to a lack of historical experience such forecasts necessarily are speculative. Nevertheless, some statements regarding growth-enhancing and inhibiting factors can be made.

Positve factors:

- There is still a high **technological potential to catch-up**: China's production per capita is only about half of Russia and only 20% when compared to the US.

- **Innovations** play an increasingly important role. For example, the number of patents already moves in a comparable order of magnitude as in the US and Europe.

- The average years of **education** for people over 25 has doubled to 7.5 years since 1980. In the 2009 PISA study, Shanghai reached excellent results, far ahead of many Western countries. Also the number of graduates from universities has increased massively over the last decade. *China Intelligence* emphasized, however, that there is still a large gap between the training and qualifications demanded by the economy. In addition, many well-educated Chinese emigrate, not least due to an impaired quality of life with environmental pollution and the high population density.

Problems and challenges:

- Increasing **inequality**: In contrast to the strong decrease in absolute poverty, inequality in income distribution has increased substantially. The growing disparities pose a serious risk to social cohesion.

- **Demographic trends**: The family planning policies culminating in the one-child rule that has been abolished only recently, initially led to a strong increase in the employed population share. This contributed to economic growth substantially. Due to the low fertility and increasing life expectancy, a significant decrease in the employment rate is expected, which is likely to reduce average per capita growth in the years to come.

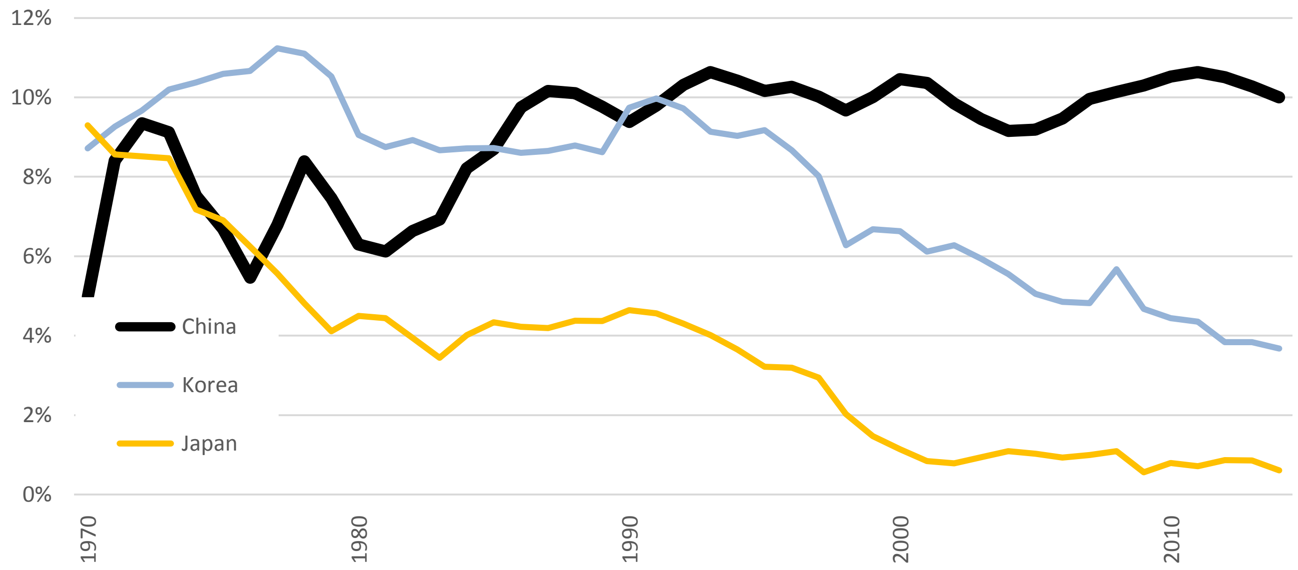
- The enormous **environmental problems**, especially water and air pollution caused by coal-fired power plants and heavy industry have roots partially in problematic incentives. The performance of a local politician has been measured by the Communist Party during the last decades almost exclusively based on economic growth. Had a provincial governor ambitions on a promotion, he tended to maximize growth regardless of resulting environmental damage. Reforms to counteract the environmental problems will require sacrifice on the growth rates.

- This disadvantage the private sector compared to the state-owned enterprises. Not compliant with a market economy is especially the bankruptcy beings. Fearing possible social unrest the Chinese state can so far to no major bankruptcies, which naturally leads to strong disincentives.

- Adverse influences also come from the **legal system**, which disadvantages the private sector compared to the state-owned enterprises. Not compliant with a market economy is especially that the government has been unwilling to tolerate any major bankruptcies, as they fear social unrest. This naturally involves strong disincentives.

- Overestimated are risks associated with real estate markets, according to *China Intelligence*. Properties in China are leveraged to a small extent: Mortgage debts in China amount to only 18% of GDP. To compare, in Switzerland this ratio is 140%: This makes the Chinese economy much less vulnerable to contagion effects in case of a downturn in real estate prices.

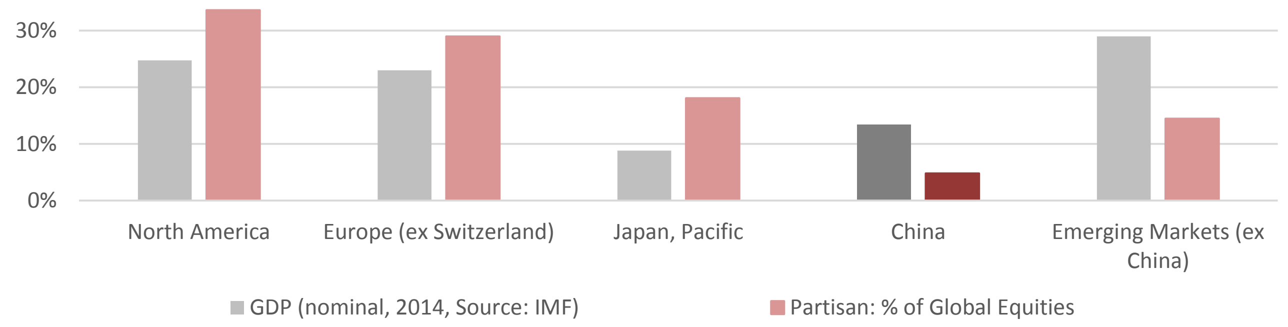
Overall, we assess the chances of a long-term continuation of the positive development quite optimistic, despite the uncertainties. After catching up with average annual growth rates of about 10% during the last 25 years, however, a gradual slowdown in growth is only natural, as was observed, for example, also in Japan from the 70s or in Korea from the 90s.



Growth rates in China, Japan and Korea (rolling 10y-average, source: Worldbank)

No Increase in Chinese Equity Exposure

The proportion of Chinese stocks in our portfolio is small compared to the economic power of China. However, despite the positive growth prospects but we refrain from an increase of our exposure for the time being.

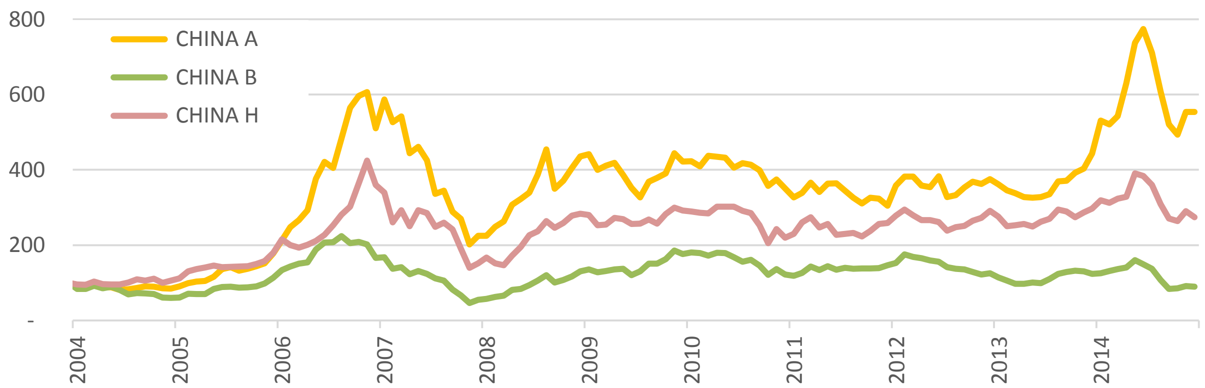


Weighting of equity markets in the Partisan compared to GDP of regions

Decisive for this decision were the following aspects:

- The **Chinese capital markets are still underdeveloped**. The proportion of freely tradable shares is strongly limited, essential parts of large companies are still being held by the state. Legal uncertainty, corruption and lack of information for outsiders bring significant risks.

- The **limited supply** in equities is opposite a **large domestic demand**: The extraordinarily high savings rate and at the same time strongly limited investment alternatives drive the Chinese in the stock market. This constellation favours the risk of excessive stock prices. This view is also supported by huge price differences in the partially segregated equity markets for domestic and foreign investors: The so-called A-shares, which may only be purchased by Chinese citizens and a few qualified foreign investors, are often traded at prices two to three times higher than the so-called B shares or H-shares traded in Hong Kong. These can be purchased by foreigners, but are not available for most Chinese persons.



Segregated markets for domestic and foreign investors (source: msci.com)

- Thanks to the large and growing engagement of European and American companies in China, we also have substantial indirectly exposure to the Chinese economy. For example, Swiss blue chips (SMI) are estimated to do already 8% -10% of the business in China.

Literature

Kjetil Storesletten, Fabrizio Zilibotti: China's Great Convergence and Beyond; UBS International Center of Economics in Society; Public Paper No. 1
http://www.ubscenter.uzh.ch/assets/publicpapers/PP1_chinas_great_convergence_and_beyond.pdf
A good and understandable overview of historical development and the prospects of China

Interesting and easy to read contributions on various aspects of China's economic development can be found on the website of *China Intelligence*: http://www.chinaintelligence.com