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## A swinging pendulum

Many of you will have noticed that, for the first time in many years, our Emerging Markets portfolio has lessened its underweight position in China, having recently added to some holdings. We thought it worth giving some context to these recent additions, given we are very conscious that the political rhetoric surrounding Sino-US relations remains quite polarised. So what follows is a brief outline of how the team are currently thinking through the myriad of competing issues, when it comes to assessing the attractions or otherwise of investing in Chinese companies.

Let's begin with what is topical: geopolitics. The flash point here is likely to be Taiwan.

While admitting the limitations of our real predictive power on this complex issue, we believe the risk of a military attack remains low. Why? First, we think it's important to recognise what China itself has repeatedly said about Taiwan. Here there has been no significant divergence from its longstanding policy, which was reiterated post

Pelosi's visit in an official white paper. This makes sense given the incredibly high risks involved in military action, which could cause devastating consequences for the Chinese Communist Party's legitimacy.

Second, contrary to popular opinions, we also note that President Xi Jinping has not specified an imminent date by which reunification must occur. In fact his personal legacy appears to be more closely tied to the success of his domestic policies such as Common Prosperity. An attack on Taiwan will completely derail that regardless of the outcome. The global response to Russia's invasion of Ukraine has made this abundantly clear.

Finally, China does not have the military capability yet, even if it wanted to attack, suggested by a third-party research report we commissioned. In 10 years' time it may become capable, but an assault over 100 miles of water would still be much more difficult than Russia's invasion of Ukraine.

So weighing up the above, we think Taiwan remains a catastrophic impact, low probability risk.



Let's move to regulation. In our previous monthly bulletin (available [here](#)), we shared our thoughts on the context and content of China's recent regulatory changes, noting that:

- Prior regulation was remarkably lax and lagged the speed of Chinese companies' innovation
- The content of the regulation itself is largely sensible; and
- We disagree with the generalised view that this is an attack on the private sector.

Then the question is, how would innovation and regulation co-exist? Here we think an understanding of China's system of governance is important, as well as its pendulum effect on business.

China is top-down and authoritarian in the sense that the state provides broad guidance for investments. However, it doesn't typically denote a national champion in advance; it lets market forces decide and as the domestic market is so large, the room for experimentation is ample, which leads to cut-throat competition. This is why authoritarianism hasn't precluded innovation, and China has produced some of the most competitive companies the world has ever seen in the last decade, some of which we have been investing in for our clients' portfolios.

But China's top-down system has significant weaknesses. One of these is the inability to communicate policies effectively. Here is an example of how communication occurs: a top governor from a central bureau with limited actual detail issues a broad guideline; this triggers an overzealous response from local regulators; in turn it results in unintended consequences such as economic weakness. This draws the attention of Beijing, which then clarifies its position, regulation is rolled back, and the balance of market versus state is restored. We have seen such pendulum effects in action over the last 18 months in platform businesses.

To be clear, we see the latest pendulum swing as helpful, but by no means the last. Just as companies will continue to innovate, so will the state continue to respond. The addition to some of the platform holdings in the portfolio reflects our view that investors are now severely undervaluing the long-run growth potential in these platform businesses, which remain integral players in China's vast digital economy.

The challenge for investing in Chinese companies in the future, more than ever, is that we need to look for policy support combined with profit motive. Fortunately, growth potential remains promising at that juncture: there are likely to be opportunities in companies facilitating the green transition, supporting agricultural development, helping to bring lower tier cities up the value chain, or enabling advanced manufacturing and industrial automation. Many of our current research ideas play into such themes. See discussion on China's 'Little Giants'.

The past 18 months has made it all too easy to conclude that China is just uninvestible. It remains our job, however, to carefully separate the assessments of macro factors from our thoughts on megatrends and where the world is going. We should stand firmly behind many of our long-standing contentions about investing in dynamic, innovative companies, and China remains home to many of those. To give but one example, China has built 70 per cent of the world's 5G stations today; the team, both in Edinburgh and Shanghai, are spending much of their time researching the likely beneficiaries of this step change. Every generation of new infrastructure gives a new breed of innovative companies: 3G brought us Tencent and Alibaba, 4G brought us ByteDance and live streaming ecommerce, what will 5G bring us? Autonomous driving, fully automated factories, what else? It pays to stay curious and keep an open mind.

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