BAILLIE GIFFORD | Emerging Markets

Emerging Markets – monthly insights

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Reflections on a recent trip to China

My father was born in rural China in the 1950s. Childhood was tough in a farmer's family with five other siblings, especially during the Great Famine (1959-1961). By the time he finished primary school, the country was under the decade-long chaos of the 'Cultural Revolution'. As a teenager, he had to quit school and work as a carpenter to support the family, but in 1978 things started to change. With the revolutionary leader Deng rising to power and gearing the country towards economic development, my father, who had by then taught himself the high school curriculum, participated in the National College Entrance Exam and got accepted by a provincial university. He then continued with a master's degree and subsequently developed a 40-year career as an English professor.

With a life of two halves, my father is one of many Chinese people who have lived through seismic changes. As we wrote in an article in 2021, *The real case for China*, this has brought a unique advantage for Chinese entrepreneurs: a vast population with an openness to change.

This was evident in my first trip back home for three years. Half the taxis now have green plates (ie, electric cars vs blue plates for combustion cars); ordering grocery via Pinduoduo has saved the hassle of supermarket visits; hiring a designated driver via Meituan local service is incredibly convenient after a few glasses of wine on a night out; WeChat has become a personal assistant for all sorts of life's duller admin tasks – beyond a ubiquitous texting and payment tool, its powerful 'mini-programs' will help you fill in a customs declaration form, book a local gym class, apply for a bank account and speak to a doctor online to get a prescription. Oh, for this utility in the UK!

Later in the trip I joined my Shanghai office colleagues to visit a few Chinese companies. Like elsewhere in the world, the pandemic has shaped their development for good and ill. In one of the biotech companies we visited, hundreds of staff had to live in the laboratory during lockdowns to ensure timely delivery of existing projects. This must have been hard, but the resulting speed at which they can now ramp up capacity to meet new demand is impressive, and management now sees a golden era of innovation when a "vast amount of data meets their deep know-how".

Conversations with another company, which makes industrial automation control parts, echoed this. Management told us that some of their Japanese and Korean competitors faced capacity and supply chain issues during the pandemic, which allowed them to quickly fill the gap and thus onboard new, sophisticated clients – an ideal way to refine the manufacturing process via feedback loops from advanced customers.

The changes that this technological innovation brings are apparent, from life in a third-tier coastal city, to labs and factories across the country. The evolving structural challenges for the country – the urge for technology self-sufficiency, the demand for cheaper new energy and the need for improving productivity – are also key driving forces for innovation. Both the companies mentioned above have delivered solid growth in recent years, benefiting from Beijing's policy shift to promoting factory automation and enhancing healthcare, as the country faces increasing challenges from an ageing population.

A report by the Information Technology and Innovation Foundation, a Washington-based think tank focused on US science and technology policy, found that China's innovation in 2020 was 139 per cent of its US equivalent, up from 78 per cent in 2010. The finding was based on a comparison of indicators including basic innovation inputs and outputs, such as venture capital and patents, and tangible economic performance outcomes such as value added in advanced industries.

All this being said, the worry that innovation and 'authoritarianism' cannot co-exist can't be ignored. To this end, the Emerging Markets Team recently spent a day at Oxford University's China Centre, where this topic was discussed.

Despite an outright violation of free-market theory, which most of us in the room were taught at school, we recognised three things that are a direct consequence of China's 'innovation machine':

1. A population that is very used to change, hence the barriers to adopting new products and services are low.
2. The capacity to operate at scale with a relatively resilient domestic supply chain.
3. An evolving, rather than fixed, relationship between the legal framework and entrepreneurship.

The third point is an interesting one. It stands in stark contrast to the strong, predictable legal framework under which western businesses operate. China's current innovation machine began developing during the economic reforms of the late 1970s, when many aspects of the corporate laws, tax rules and land registries were left flexible. This allowed entrepreneurs to develop a more localised relationship with local governors, who often serve as deal 'brokers' rather than deal 'blockers'. Practices then evolved into rules via trial and error, forming a pragmatic system of innovation – as the old Chinese saying goes, "crossing the river by feeling the pebbles".

While this doesn't necessarily sit comfortably as a model for economic progress, where transparency and assurance in a legal framework seem critical, it is a useful context for thinking about China's development. China has 1.4 billion people, 34 administrative provinces/regions, more than 160 cities with one million or more residents, and a large economy with 40 million SMEs (small and medium enterprises) across multiple industries. Despite a top-down system, the majority of the decision-making in China happens at lower levels.

The weaknesses of this system are clear, however, as per our previous discussion on the pendulum effect of Chinese regulations. Any investment strategy based on a strongly held view of particularly positive or negative policy support for corporate China seems ill-judged to us. History has shown the regulatory landscape to be wildly unpredictable and there is little to suggest this will change, so portfolio construction and risk management must respond accordingly. Some modest reduction recently to our larger position in Chinese financials reflects this.

So where does this leave us? We will continue to identify the fastest growing, most innovative businesses available in China, favouring those that appear most aligned with state policies and aims. Our on-the-ground research suggests that there is an abundance of riches to choose from. But we will remain humble about our ability to predict both the direction of regulation and the risk premium investors will be willing to pay for Chinese companies. As always, having as many individual, idiosyncratic risks in the portfolio as possible remains the goal. Similarly, taking risk in areas where it is possible to have higher conviction has historically proven to be a profitable strategy. Where this leaves us at present is underweight in Chinese companies.

Qian Zhang, Client Director

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