

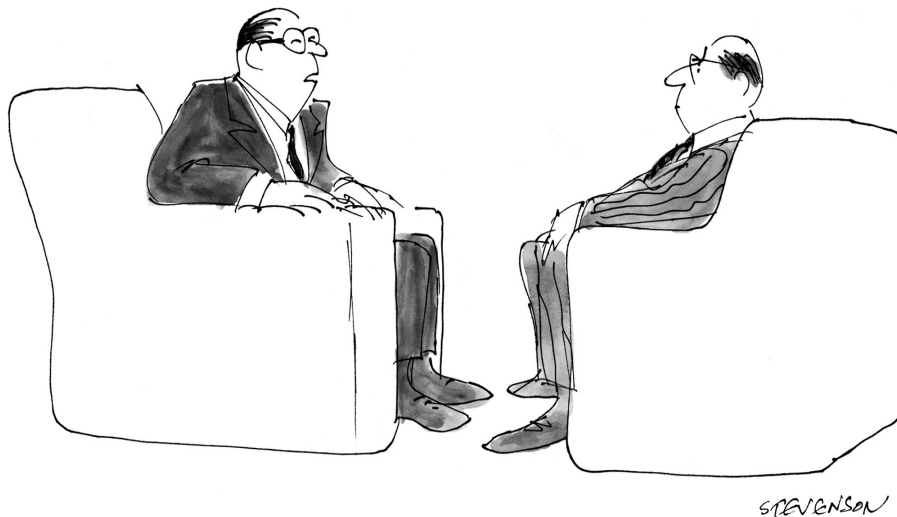


**PACIFICUS**  
CAPITAL MANAGEMENT

Investment Outlook – October 2021

## Why I Do Not Invest in China

*"It takes many good deeds to build a good reputation, and only one bad one to lose it."*  
- Benjamin Franklin



*"To be completely frank, we have now discovered all your country's secrets, except how to make a million dollars in one's spare time at home with no personal investment."*

When it comes to investing, I have made it a point to not get political. Much of what we as individuals believe is subjective, based on experience, perception, and unique circumstances. My job as an investment manager and adviser is to manage risk, help grow my clients' wealth, and assist them in planning for their financial future. My political and philosophical beliefs may match many of my clients' views at times, but often they do not. I find injecting politics into one's investment process adds unneeded stress into an already stressful endeavor. As an investment manager, I am responsible for interpreting and reacting to events – not instilling my will or beliefs on how things ought to be.

With that said, I have made it a point over the years to stay away from investing in China. No government is perfect, but some are considerably less perfect than others.

Large scale human rights abuses ([see a recent shocking CNN piece here on the Chinese Communist Party's torture against Uyghurs](#)), unfair trade practices, and dishonest dealings both internally and externally have shaped my negative opinion over the years.

When analyzing China's economic statistics, no one knows what to believe. Many experts attempt to "correct" for inconsistencies and focus on getting the overall direction or trend mostly right, rather than the magnitude of periodic changes. This seems like a guessing game to me, and so I'd rather not play.

Given China's position as the second largest economy in the world, it is impossible for most go-anywhere investment managers to avoid indirectly investing there. For our part, my clients do have decent exposure to various countries and industries within the Asia Pacific region, where China is a major trading partner and/or product input provider. Nevertheless, this is where I have decided to draw my line.

Jason Zweig writes The Intelligent Investor column for The Wall Street Journal. In a recent piece, "What the 'Smart Money' Knows About China's Evergrande Crisis," he reminds us of the pitfalls of investing in China. Namely, the high risk and paltry rewards achieved since the early 1990's.

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### **What the 'Smart Money' Knows About China's Evergrande Crisis**

*On Wall Street, hype almost always leads to heartache. Investors who hopped on the China bandwagon are learning that lesson the hard way.*

By Jason Zweig  
September 24, 2021  
The Wall Street Journal

**NOBODY KNOWS ANYTHING.**

In all its original screaming capitalization, that line from "Adventures in the Screen Trade," William Goldman's 1983 book about Hollywood, sums up the fiasco of China Evergrande Group and the global investors caught up in its collapse.

As the late Mr. Goldman did in his book, I'm going to repeat the phrase, so it will sink in.

**NOBODY KNOWS ANYTHING**, because Chinese corporations and their investors are hostage to the whims of Xi Jinping, who is effectively the country's president for life. Executives, companies and entire industries formerly favored by Xi and the ruling Communist Party have been stripped of power and value without warning, making foreign investors look like fools.

And NOBODY KNOWS ANYTHING, because even if professional investors—the so-called smart money—did have special insight into what the Chinese government was going to do next, they would hardly be able to act on it. Were they to do so, that might lower your risk—but it would almost certainly increase theirs.

Because NOBODY KNOWS ANYTHING, investors should be sure they are comfortable with how much exposure they have to China.

On Wall Street, hype almost always leads to heartache, and the experience of people who have hopped onto the bandwagon of investing in China has so far been no exception.

U.S. mutual funds and exchange-traded funds investing primarily in China held \$43 billion in net assets at the end of August, up 44% from 12 months earlier, according to Morningstar. Over that time, investors added about \$13 billion in new money.

More than one-fourth of the total assets of these funds has come in over the past year alone—just in time for a long march of losses. Since its peak in February, the MSCI China index has lost 30%.

What about the longer term?

Between its inception at the end of 1992 and this Aug. 31, the MSCI China stock index has returned an average of 2.2% annually, including dividends. Over the same period, the MSCI Emerging Markets index grew 7.8% annually; the S&P 500, 10.7%.

That covers a nearly 30-year period in which China's economy often grew by at least 10% a year. Nevertheless, you would have earned much better returns on U.S. Treasury securities than on Chinese stocks. Maybe China, which holds more than \$1 trillion in U.S. Treasuries, knew something that Wall Street didn't.

And knowing what the Chinese government is thinking is harder than ever.

Late last year, as my colleagues Jing Yang and Lingling Wei reported, President Xi personally intervened to squelch the initial public offering of Ant Group Co., shortly before the financial firm could launch what would have been the largest IPO in history.

Since then, the government has slammed Alibaba Group Holding Ltd. with a \$2.8 billion antitrust fine that state media called “also a kind of love.” It blocked Didi Global Inc. from adding new customers just days after the ride-hailing firm went public on the New York Stock Exchange. In July, shares in New Oriental Education & Technology Group Inc. and TAL Education Group fell roughly 70% in two days after Communist Party authorities issued an edict that would force tutoring services for children to be run as

not-for-profit operations. The companies themselves never saw it coming, and Wall Street analysts had been blithely touting the stocks.

In the latest incident, property developer China Evergrande is on the brink of collapsing under its enormous debt burden; only recently did Chinese authorities stop flooding the real-estate market with cheap credit.

Many analysts, commentators and investors are calling China's recent actions a "regulatory crackdown."

That isn't what's happening, though, says Andrew Foster, chief investment officer at Seafarer Capital Partners LLC, a global asset manager in Larkspur, Calif.

"These are not regulatory events," he says. "These are policy interventions to reshape Chinese society, guided by Xi's personal agenda, intended to effect objectives that aren't always knowable."

Because that agenda is fluid, opaque and unpredictable, says Mr. Foster, "investors should be very cautious about relying on past experience when forming expectations about future investing outcomes." Seafarer does invest in China, but its main fund has only about 20% of its assets there.

That's substantially less than leading benchmarks that track emerging-market stocks, where China was 34% to 37% of total capitalization at the end of August.

Most fund managers won't deviate far from those indexes, and here's why.

They don't want to be what investor Mark Kritzman calls "wrong and alone." A manager with one-third of assets in Chinese stocks won't get fired if that market falls, since almost every other firm has similar exposure. Being wrong together gives every manager plausible deniability.

But a firm that holds little or nothing in Chinese stocks will be blamed by clients if China booms, since its funds will lag behind their competitors. Being wrong and alone is what gets asset managers fired.

So NOBODY KNOWS ANYTHING because most investment firms, whether they passively track a benchmark or actively pick stocks, have chosen to echo the weights of China in leading market indexes, no matter what happens.

That helps explain why major fund managers continue to urge investors to pour more money into China, emphasizing its potential while playing down its past disappointments and ominous current policies.

“Index providers say they don’t tell people how to invest, and fund managers say they have to track the benchmarks, so it’s this never-ending circle of nobody taking responsibility,” says Perth Tolle, founder of Life + Liberty Indexes and creator of Freedom 100 Emerging Markets, an exchange-traded fund that owns no stocks in China. “Wall Street will twist logic and do mental gymnastics,” she says, “but it’s investors who end up getting hurt.”

In my opinion, the Wall Street belief that Beijing is bound to move toward free capital markets is based on shaky evidence.

Chinese governments have been meddling in the stock market since the 19th century. Again and again, the authorities inflated bubbles with cheap credit, planted government officials on corporate boards, micromanaged daily operations and subverted the rights of outside shareholders. Even in the early years of Communism under Mao Zedong, the government ran, and ultimately wrecked, several stock markets.

Today, China constitutes about 4% of total value within the MSCI ACWI index of 50 developed and emerging markets around the world. In theory, an investor should have that much China, but no more, in a global stock portfolio. If, for instance, you have 10% of your assets in an emerging-markets fund which, in turn, has one-third of its holdings in China, then you’re looking at about a 3% total exposure.

Until Beijing stops using the stock market as a plaything, that’s plenty. Anyone who tells you that you need to invest more than a tidbit in China is asking you to bet that the future will be nothing like the past.

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If you read or watch financial news, riding the inflation bandwagon is where it is at. Almost every market pundit has been pounding the table on why inflation will not be transitory, and why bond yields (particularly long-term yields) should be much higher than they are today. Please keep in mind, many of the loudest voices pushing this narrative have been wrong on bond yields for many, many years. I doubt this time will be any different.

Prior to managing money for individuals, families, and non-profits, I worked on Wall Street trading desks for various bond and interest rate derivatives dealers. Over the years, the traders and strategists who bet on yields falling seemed to be the quietest, yet the most consistent winners on the desk. Taking a quick glance at a time series of thirty-year treasury bond yields from the early 80’s onward should help confirm this for those who were not around.

I believe the recent spike in inflation numbers are transitory and ultimately the year over year comparisons will mean-revert to the low inflation trend that has been with us for

decades. Fiscal stimulus is rolling off and will be an impediment to both growth and inflation going forward, while supply chain disruptions should eventually ease. However, the disinflationary macro picture for developed economies – high debt, globalization, technological advancement, and aging demographics are trends that remain firmly in place.

I believe interest rates will continue to remain historically low, which should be helpful for interest rate sensitive sectors of the market such as real estate and technology. Nothing goes up in a straight line, however the trend in this instance remains our friend.

| <b>ASSET CLASS &amp; SECTOR OPINIONS</b> |   |  |
|--|---|--|
| <b>OVERWEIGHT</b>                        | <b>NEUTRAL</b>                          | <b>UNDERWEIGHT</b>                       |
| U.S. Real Estate & Related Equities      | Communication Services Sector           | Small Capitalization Stocks              |
| Large Capitalization Technology          | Leisure & Hospitality                   | Financial Services Sector                |
| Consumer Discretionary Sector            | Gold & Gold Miners                      | Consumer Staples                         |
| Healthcare Biotech & Pharmaceuticals     | Mortgage Backed Securities              | Materials Sector                         |
| Aerospace & Defense                      | Local Currency EMG Bonds                | Leverage Loans (Floating Rate Debt)      |
| Emerging Markets Equities                | High Yield Corporate Bonds              | Treasury Inflation Protection Securities |
| U.S. Treasury Notes & Bonds              | Energy Related Equities                 |  |
| Investment Grade Corporate Bonds         | International Developed Market Equities |  |

Sincerely,  
Justin Kobe, CFA  
Founder, Portfolio Manager & Adviser  
Pacificus Capital Management



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