THE SELLOFF IN CHINA AND WHERE WE STAND

1. In both of our global strategies, we own two of the largest Chinese internet names. Each stock is trading at such compressed valuations that, from current levels, the 52-week returns have historically been phenomenal.

2. In the past, when the stocks have traded to these same valuations, it has inevitably been the result of the Chinese Communist Party’s (CCP) incursion into their respective businesses. Fundamentally, the revenue and earnings power of these companies was just too great to otherwise explain these levels of depressed valuations.

3. The delicate relationship between a centralized state government and thriving capitalistic companies creates a permanent level of tension amongst foreigners investing in Chinese stocks.

4. Therefore, when that relationship becomes more tense, investors react by selling. Political noise in China creates an even quicker “sell first, ask later” response than in the western world.

5. As articulated in #1, for long-term investors with patience, selling has historically been the worst thing to do.

6. Therefore, we need to ask ourselves two questions:
   a. Is this time different for the CCP?
      Is the party trying to destroy their tech giants, or simply reminding them and their billionaire leaders who is really the boss?
   b. Have the core operating business fundamentals for these companies deteriorated?
7. The social contract of the PRC is zero political freedom in exchange for the opportunity for wealth creation. Absent the ability for citizens to become wealthier, lack of political freedom becomes a greater concern.

Here is a great quote which I think aptly summarizes the point:

As one Shanghai businessman said, “When I was growing up, textbooks tried to convince us about the decadence of rich Americans’ pets enjoying air conditioning, a luxury few Chinese dreamed of having in those days. Today, my neighbor’s dog will only drink Evian.”

These large companies are facilitating wealth accumulation and improving the everyday lives of Chinese citizens. We doubt the CCP would dare reverse that.

8. It would appear the CCP currently has two key points of contention:
   a. Rein in listings outside China, given the party’s concern about access to private data.
   b. Insuring against any anti-competitive practices, given the power and might of these large companies.

9. Imagine if there were a U.S. company that had private data on tens of millions of Americans….

   That was only traded in China…
   Would US lawmakers react differently?

Last week, the US Defense Department ripped up its previously awarded JEDI contract agreement with one company. As the WSJ reported, “the Pentagon had been facing pressure from lawmakers to award the contract to multiple vendors”.

10. In no way am I trying to defend the CCP, but situations like this are never exactly black and white. “Us good, them bad.” When sentiment has swung so far one way, it’s usually time for calmer heads.

11. Fundamentally, we do believe some Chinese companies are experiencing headwinds in the form of increased competition. However, remember that the Chinese consumption appetite is likely decades from its peak.

12. We do expect Chinese stocks as a group will continue lower in the near-term, as the flush of US retail selling does not yet appear to have run its course.

13. Nevertheless, we think the right thing to do is to hold our positions in these long-term winners, at least for now.

But, we are asking the tough questions daily, and nothing is sacrosanct!

Andrew
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