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A VIEW FROM ASIA

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- July was challenging for investors in Asia and Emerging markets.
- Thankfully, our fund was positioned to shield us from the worst of outcomes.
- After the sell-off and the growing distaste for Chinese equities, I am setting myself up to buy into stocks at much better valuations.

JOHCM Asia ex Japan Fund

Doctrine – a belief or set of beliefs held and taught by a Church, political party, or other group

In a society, norms and customs morph over time. In Leviathan (1651), Hobbes argued that the absolute power of the sovereign was ultimately justified by the consent of the governed, who agreed, in a hypothetical social contract, to obey the sovereign in all matters in exchange for a guarantee of peace and security. There are others (including a number of American founding fathers), who favoured the ideas of Locke, particularly the assertions that men had natural rights, rulers should derive their authority from the consent of the governed, and the governed had the right to overthrow governments that abused their rights.

I have studied neither philosophy nor politics. Investing in markets has helped me understand, in an imperfect way, the driving motivations of countries and companies. As the fissures between the US and China escalate, it is critical to evaluate the philosophical motivations and understand potential outcomes for our investments. Concurrently, differences cropping up to the fore within societies might also lead to profound changes and affect our investments.

In the post-Cold War world, The **Friedman doctrine,** also called **shareholder theory,** has held sway. According to Wikipedia it *'is a normative theory of business ethics advanced by economist Milton Friedman which holds that a firm's sole responsibility is to its shareholders. This shareholder primacy approach views shareholders as the economic engine of the organization and the only group to which the firm is socially responsible. As such, the goal of the firm is to maximize returns to shareholders. Friedman argues that the shareholders can then decide for themselves what social initiatives to take part in, rather than have an executive whom the shareholders appointed explicitly for business purposes decide such matters for them. The Friedman doctrine has been very influential in the corporate world but has also attracted criticism.'*

The crackdown in China

I mention this to highlight the moves by the Chinese authorities across several fronts and put those actions in perspective. I do not judge who is right or wrong, but weigh the motivations and act accordingly. The diktat from China for the private tutoring sector has effectively crippled it. Ordered to become 'non-profit', desist from raising capital, and shun foreign teachers, the sector has become uninvestible overnight. Several commentators were furious and accused the government of hurting foreign investors. Is this behavior unique? A blunt clampdown might be; but what about the underlying principle?

Take a look at the US to witness the state of finances for students and universities. Over the past decade, one of the single largest sleeves of debt that has spiraled out of control relates to student debt. There is clamor (mostly from the left) for writing that debt off. Many politicians demand free education at community colleges. It just goes to buttress the point that in every human activity, there are multiple stakeholders.

From Caixin, a leading Chinese news source *"A recent survey of 4,000 parents by the state-backed newspaper China Education Paper found that 92% enroll their children in extracurricular classes and that half of families spent more than 10,000 yuan ($1,500) each year on such classes. The term often used to describe this situation in China's education is "neijuan," or involution, which literally means, "inside rolling," a process of incessant competition from which no one benefits. Chinese parents feel intense pressure to provide the best resources to their children, who in turn must work extra hard to keep up in an educational rat race."*

On Zhihu, a Chinese social website for questions and answers (similar to Quora), almost all comments from parents are against the government's new regulation of cram schools. *"This is like America's Prohibition Act. You can ban alcohol, sure, but does that mean that people don't want alcohol anymore?"* posted one commentator. *"Same with banning cram schools. If you close them, does that mean parents do not want to send their kids to these schools? The demand is still there. It's just becoming more costly."* Another posted, *"Only half the students graduating from Grade 9 are allowed to go to high schools. The other half have to go to vocational schools. There is a quota now. But what parents want their children to become blue-collar workers? They'll do everything possible to make sure their kids score well enough to be the top half."*

Unfortunately, the ban on these education companies does not solve a real problem for parents who want their children to get supplemental education. In effect, those who can afford to pay will hire personal tutors while the State will pressurize existing schools to provide alternatives, which might be sub-par. There are no perfect answers. Fair access to quality education at an affordable price are universal problems for almost every society. Each society has their ways of dealing with pressures from stakeholders. The one lesson I take away from this episode is that when one stakeholder 'extracts' disproportionate benefits, the backlash will be felt over time.

Contractors vs employees

Consider the admonition and regulations dished out by the Chinese authorities to Meituan Dianping (the food delivery firm) on providing fair wages and benefits to its delivery riders. A stock we own, it suffered a sharp sell-off on news of further tightening of regulations. The authorities had three choices when it came to imposing better pay conditions – low/high/middle benefit coverage for the workers.

- Low coverage proposal: classify all the workers under a contractual relationship instead of a labor relationship – meaning they are not staff of the company. Companies do not provide social benefits but shift the burden to the individual or the State.
- High coverage proposal: classify all the workers under a labor relationship, meaning full coverage would be provided by the company. This would add significant costs to platforms such as Meituan which would potentially also be passed on to consumers.
- Middle coverage proposal: Only a very small group of workers are classified under contractual or labor relationships. The majority would be classified under some middle form of labor. The only insurance that the platforms are required to provide for these workers is occupational injury insurance. The rest are up to the workers themselves to fund.

From what I gather, authorities have agreed upon the middle path, greatly reducing the uncertainty on compensation for labour. Over time, this might still be subject to change if societal pressures force a rethink. As of now, the cost increase for the platforms will be only a few cents per order. In my view, that burden is bearable – it will reduce profitability in the near term but not structurally damage the business. Markets ignore the bigger and more relevant case for continuing to own the stock. This service is crucial for society – imagine life without the ability to order food during this pandemic. Restaurants and delivery riders have fair demands but the platform delivers an essential service. Besides, after stringent regulatory requirements, in my opinion, no startups are likely to raise capital to challenge Meituan's dominance. During the worst of the sell down, I added to our holdings.

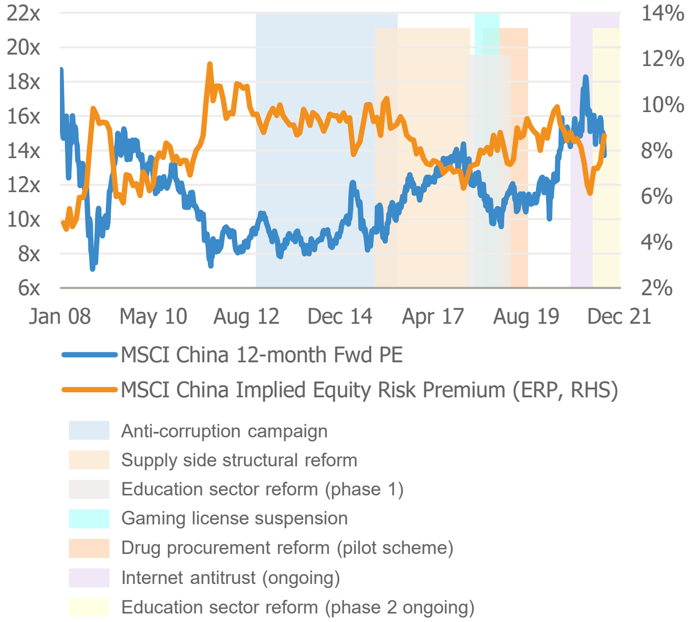
Contrast this to the US - in January 2021, the State of California passed a law AB5 *"supposed to make it harder for companies to hire workers as contractors. Supporters of Assembly Bill 5 say companies have been exploiting contract workers for years because they are not considered employees who get benefits like health coverage and workers' compensation. The law touches many industries, from trucking to tech to certain medical professions. AB5 does include carve outs for professions such as dentists and attorneys."* In May 2021, under a ballot initiative called Proposition 22, California voters handed Uber and Lyft a big victory when they approved a measure allowing the ride-hailing companies to keep classifying their drivers as independent contractors.

If you are a steward of capital adhering to the principles of ESG, which of these outcomes is preferable?

What can go right?

July was challenging for investors in Asia and Emerging markets. Thankfully, our fund was positioned to shield us from the worst of outcomes. The sell-off was furious and sometimes indiscriminate. Some clients questioned "should we even bother investing in China?" To which my answer is a resounding yes. **We now have to ask the question – what can go right?** If you reflect back to 2015 and 2018, we had sharp sell-offs across Chinese equities in both years. Once we got past them, what mattered is what still matters today – liquidity, earnings progression and valuations. In my view, the regulatory risks in China always existed; it's just that we are now more attuned to them. That should not be an excuse for revulsion. I am running screens to identify the businesses we can own over the next two to three years or longer. The timing of recovery in stock prices is difficult to predict. Risks abound. Yet after this sell down and the growing distaste for Chinese equities, I am setting myself up to buy into stocks at much better valuations. As always, time will tell.

A risk a year keeps the investor at bay



Source: Morgan Stanley estimates.

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JOHCM Asia Ex Japan Fund
5 year discrete performance (%)

Discrete 12 month performance (%):

	31.07.21	31.07.20	31.07.19	31.07.18	31.07.17
A USD Class	37.87	17.24	-2.84	-7.19	18.97
Benchmark	19.08	12.20	-2.92	5.14	27.28
Relative return	15.78	4.50	0.08	-11.73	-6.52

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg, NAV of Share Class A in USD, net income reinvested, net of fees as at 31 July 2021. The A USD Class was launched on 30 September 2011. Benchmark: MSCI AC Asia ex Japan NR (12pm adjusted). Performance of other share classes may vary and is available on request.