



## Holland Macro Views

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# My China investing reflections

A great deal of change is occurring in China's investing markets and Government policy. A great deal is also being written about these events also. Some of this commentary is balanced and considered but not much. What this piece serves to do is to:

- a) Revisit some of the ideas and views we expressed in the Alibaba piece published in June. Despite only a few months ago a great deal has happened in attitudes toward investing in China since.
- b) Highlight a number of excellent sources of material (investor letters and Twitter accounts) whom I have personally found hugely helpful during this period. They are not universally bullish, but are all looking for balance in how they assess recent new policy announcements. These people's insight is excellent.
- c) I add some new reflections. Whilst these are my own (i.e. I have not seen anyone else talk of the impact on the capital cycle and how by starving new competitors of capital it will help incumbents). A number will also have come from others' ideas who I agree with.

### Ideology + Consistency bias

Our Alibaba piece in June (re-attached) had a section that reflected on investing in China and how investors should think about it. We take the liberty of repeating that section below. We do not do so because it was right. Indeed, last time I looked Alibaba was priced at \$160 vs our note at \$210! We do so to try and show our thinking at the time. Then we were already stating that it was not about the 'right' or 'wrong' way to run a country, but a 'different' way. We think this is good context for recent policy changes by the China Communist Party (CCP). Perhaps more importantly also for many investors' reactions towards them. In Mr Markets view of China we see a dangerous mix of ideology (our way of capitalism is the only right way) and then the search for consistency bias to re-enforce that view.

### Extracts from our June 2021 Alibaba research

*The other day we found ourselves reflecting on the investment prospect that is Alibaba rather more holistically. That is to say against country risk, political risk and where it sits in a world of uncertainty, but opportunity too. We found ourselves noting what it was that turned the tide of sentiment towards the company.*

*Was it Jack Ma's speech or the government crackdown on Ant Financial that resulted in its pulled IPO? The following article is a fairly representative mainstream article<sup>1</sup> (from Forbes) on this point.*

*Clearly these types of articles give a different and important insight that we need to take on board. Has value been taken away from Ant group and Baba since last summer? Yes of course, but is that fact also discounted in the share price too? Is Jack Ma's power*

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<sup>1</sup> <https://www.forbes.com/sites/georgecalhoun/2021/06/07/the-sad-end-of-jack-ma-inc/?sh=174c2f9f123a>

being neutered somewhat? Yes. But is he also showing great signs of contrition? Also, yes. We never said this was easy.

*Looked at another way – Different or wrong?*

*Maybe a capital light financial service business that in ten years had grown to be the size of JP Morgan with a small amount of capital should have just been allowed to keep growing without any checks or balances? Would that have been a good thing? Have we seen that type of thing before elsewhere in the world, and if so how did it turn out..?!*

*There is always a danger that you look at a foreign country through too much of your own eyes and assume that a different way of doing business is a wrong way of doing business. The same being said in the case of regulation. Whilst investors in a 2019 capital-light Ant Financial will no doubt feel aggrieved at the requirements made of it going forwards, these policies are not necessarily anti-Alibaba or anti-Jack Ma any more than they are anti-capitalist. However, we concede they do represent a different way of doing business than many in the West are maybe used to. One where the state will step in early if it feels a situation might get out of control, or indeed an individual has. Surely even those of us who are pro free markets and ardent Ayn Rand fans have seen enough of what has happened in financial markets in the last ten years to see that there could be some wisdom in these sorts of actions if taken at face value. I.e. a little early shoring up of fast growing financial services companies might not always be a bad thing.*

*Crucially **It also does not stop them being good companies into the future.** We note for example that Alipay is the main sponsor of the Euro2021 football tournament! However, we in the West have no experience of this (i.e. early regulation) as we have never seen it before as we only ever see ‘after the event’ type regulation. (Northern Rock, Lehman) Maybe, just maybe Ant Financial comes back much bigger and much stronger X years from now? Maybe, just maybe Alibaba, a long-standing Chinese company that has not just been founded by a ex-US Harvard student in time might be looked on a little more favourably by the Nation state it has sat alongside for many decades now.*

*That the company and Jack Ma have been contrite ceding to China’s wishes once they realised, they crossed ‘the line’ we think important. We accept this is a different place to invest, but that is different to it being an impossible place to invest. All risks after all are there to be priced, ask Ajit Jain. That said, it is probably not somewhere for Michael O’Leary to run a company!*

*In short*

*We are not naïve and we enter into this type of investment with our eyes wide open. We see the risks, but we see the opportunity too. What is important is to be objective and in order to do that you have to think and occasionally reflect as we just have above. You also have to consider that you are maybe paying in many cases PEG’s of 2x for large US predictable growth companies (i.e. PE of 25x for growth of say 10-12%, if you are lucky). In the case of Alibaba you might be paying a PEG of 0.5x (12x for growth of 20% pa). That is one hell of a risk reward pay off. Only a few years (even months) ago investors were only focused on the growth potential of this business. Seemingly now they can only see its risks. That change of heart set against secular growth appeals to us greatly.*

**Source: Holland Views: Alibaba - Deferred Gratification, June 2021**

## Greater minds

Over the summer Chinese rule makers came out with a new policy almost daily and share pieces spiralled lower. During this time we found some wonderful commentators on the subject, inside and outside China. In particular I would like to call out @ruina and @lillianmli on Twitter. Their combined closeness to the end market combined with their rationality towards what new policies might be designed to achieve were both excellent (#I am Sea Turtle fan).

I also recently read a couple of investor letters that I thought summarised recent events in China succinctly. The thinking they overlaid on them also resonated strongly with my own. This was true both as to my view when writing in June, but also as it evolved as new news emerged. Whilst I am sure there have been others the two I thought by far the best were:

- [Hayden Capital Quarterly Letter 2021 Q2.pdf](#)
- [RV Capital First Half Letter 2021](#)

## My new reflections

Whilst I attribute some of my new reflections below to those above, if I do not attribute enough, I apologise. I thought both letters and the two Twitter accounts brilliant and I thank those that took the time to write them. Readers are assumed to be aware of policy announcements made recently by China and already having read (likely a fair bit) on this subject.

### Vive la difference.... if it works

We alluded to this idea in June (extract above) and this point gets to the core of the different investor interpretations of events in China. Is a planned capitalist economy worse than an unplanned one? I do not know, but importantly also don't feel the need to try to answer the question. Only to state that I am open minded. Whilst the knee jerk reaction of share prices has been negative to each new policy item, it has been interesting to read some commentators from a different angle:

- A CNBC anchor man stating that he would love to enforce a one hour per night gaming rule in his house, but his children would never accept it
- An FT article that reflected on the China education sector changes and how they followed in the footsteps of changes in South Korea and had longer term merit/benefit to the Chinese economy

These observations, amongst many others, point toward changes being difficult to enact (even with short term unpopular consequences), but actually admirable and logical. Against this context we thought Lillian Li's observation below poignant. It speaks to the different approaches each economic area has and how we should all look harder to understand their subtle differences.



Lillian Li  
@lillianmli

China: Innovate then regulate.  
Europe: Regulate then not innovate.  
US: Innovate then not regulate.

7:35 AM · Jul 7, 2021 · Twitter for iPhone

Source: Twitter

### Your point of view

In our Alibaba piece we talked to the investment opportunity in the company. We also spoke about the biases many investors had towards China and how they were quick to air these in the face of Charlie Munger's investment in the company (i.e. why he was wrong and they were right). The last three months have seen yet more biases come to the fore and others re-enforced:

- **Framing** – If say Canada under a new political party were to gradually pass many of the changes that China has done, would it be perceived to be the end of free markets or labelled 'long-term capitalism' or 'responsible capitalism'?
- **Re-enforcement bias** – With an ingrained US political rhetoric that puts China as a modern-day enemy its actions are too easy to assume as wrong by many. Equally a love affair with the US system of ultra-free markets and capitalism can easily pit you against any suggested alternative.
  - On this point we cannot help but note the biggest exponent of the US system of capitalism and its amazing long-term success is Warren Buffett. Sitting alongside him is Charlie Munger. Charlie whilst agreeing on capitalism's power and success has also been a huge fan of both Singapore and China in the way they have grown and structured their economies.

*"The test of a first-rate intelligence is the ability to hold two opposing ideas in mind at the same time and still retain the ability to function."* **F. Scott Fitzgerald**

### Does where we sit help?

Western markets are clearly dominated by US investors and the commentators that come with them. Your author is based (and has always been based) in London however. At times that will come with disadvantages, but on this issue, we wonder if it helps. In Europe you are forced to look West and East. Also importantly to look at close country neighbours (the closest only 22 miles away). Each with different cultures, rules and attitudes towards running their economies. Whilst many believe their own system is clearly best, over time objectivity is forced upon you. If you look closely differences are not so far away:

- The UK's completely unregulated house price market means that second home owners push up prices in places like Devon out of the reach of locals. By contrast in parts of Switzerland local and outsider permits are required. These help with local affordability
- In Germany rent inflation is still capped in places and the past rights of tenants to stay in some housing for a lifetime protected. Both have limited excess residential property speculation
- In UK/EU almost all countries have Value Added Tax (VAT). The US does not
- The Germany/French economies are far more industrial focused, on occasions stepping in to protect national champions. The UK by contrast is more US-like, more open to the free movement of capital flows (both good and bad) and consumption orientated

The specifics of these differences are not important. Instead it is the realisation that a different way to manage an economy can work over time also. We wonder if the success of the US capitalist system and the scale of growth that is possible to achieve just within its domestic boundaries blinkers some investors on this issue?

### Speed of change

Humans do not like revolution, preferring evolutions. As such the events in China are in actual fact perhaps more shocking for their speed than the new policies themselves (a good deal of which seem based in sound logic from your authors point of view). The quote below we think interesting:

*When exercising authority, start sternly and then exercise leniency.  
If you start leniently and then become stern,  
People will resent you ...*

Hong Zicheng, Daoist, 16th century CE

(With thanks to Cederberg and China Watch for highlighting it)

Clearly none of us know what comes next. The fear of ever more changes suggest to some that this is all a step back towards the China Communist Party's (CCP) past. Or we could look at it differently:

- Does the fact that so much new policy is coming in different sectors of the economy suggest a desire to get things done and quickly, as per the quote above?
- Indeed, if we look at it differently how amazing would it be to have a super tanker that you were able to change direction quickly in this way? Many Western policy makers might be quietly envious of such an ability
- If new policies are definitively bad for the economic dynamism of China, then whether brought in quickly or slowly they will do damage. But if they are not then getting change over with quickly is normally a good idea
  - Indeed, at a corporate level (management succession or redundancies ++) investors would normally welcome quick changes
  - The only thing making investors feel dizzy currently is that they are so used to the glacial pace of change of Government policy in the West
- During the summer the occasional step in by Chinese regulators and commentary by officially approved news channels were helpful in this regard i.e. they have occasionally guided investors that. *'we are not trying to kill capitalism or growth and that the VIE structure is not under threat'*
- Could a day come in the months hence where the CCP states that the *"major changes it wanted to implement are now largely complete."* What might happen to investing sentiment in China and share prices if that occurred?
  - More likely we concede no such announcement will occur and new policy announcements slow
  - Investors then will just gradually adapt to the new normalcy of investing in China

### Growth + Capital cycles matter more

One area that we think that has not received any airtime in this period is the second order consequence of recent intervention and its affects. In our Alibaba piece we marvelled at the company's speed of past growth, market position and ongoing innovation. However when looking at peers like PDD we were forced to concede that all in China were moving very fast. Thus, competitive advantages were harder to be sure of looking forward. Might the events of the last few months change that:

- Appetite for new investment in China has collapsed in recent weeks. From a capital cycle perspective that is important. When the underlying market is growing fast it enables those with already established shares to solidify their market positions and do so quickly.
- That in areas like cloud the Chinese authorities have moved to keep data in China. Also having government approved providers might only strengthen those already in high market share positions?

Clearly if these incumbent companies become lazy bureaucratic beasts in the future under quasi-government protection then innovation and growth will suffer. However the level of innovation we observed in China before these changes vs that in the West was simply mind boggling. This



fact suggests this a very unlikely scenario. More likely what we are seeing is rule improvements to encourage better long-term behaviour of otherwise very competitive market participants. However if in the uncertainty it creates a pause in new entrants that is helpful to incumbents.

### Growth is still key

Growth is still a key requirement for the future success of China and the CCP fully understands that fact. If a Western armchair economist dismisses this idea they are a fool. The scale of economic and societal achievement (and the complexity in delivering it) in countries like Singapore and China in the last 40 years is nothing short of miraculous. It did not, and could not, happen by chance. Interestingly many of the policies being enacted are designed to promote growth in the longer term (e.g. education changes to encourage larger families/encourage high growth sectors/reduced gaming to have a more productive young adult population). The difficulty in the interpretation of them is more likely ours as we strive to frame them in the context of our own lives and the governmental actions we are used to. Also that Western investors are so used to non-intervention in markets they cannot accept that it might be a good idea.

*“Common prosperity is not egalitarianism – it is by no means robbing the rich to help the poor as misinterpreted by some Western media”.*

**Source: Official Xinhua News Agency/FT**

### Serial re-investors – Nothing new

Post the CCP recent reiteration of its “common prosperity” message a few larger ecommerce businesses were quick to get out their cheque books. Clearly this can be seen as a ‘take’ from what otherwise would have been the pool of shareholder capital. On this issue we observe two contrary points:

1. Do these companies largesse establish them in the eyes of the CCP as ingrained players who have been helpful to the cause? It is hard to see a new NASDAQ float company acting in the same way. This follows on from our capital cycle point. Do these actions solidify established markets positions in the longer term?
2. Whilst we do not know the Tencent business we re-iterate what we outlined in June, i.e. that Alibaba and PDD are serial re-investors in their businesses...on a massive scale. Indeed it is this business model (rather than China per se) that first attracted us to \$BABA.
  - Such re-investors normally invest in price or customer service, but not always (e.g. JDW spent a few years re-investing in staff post the minimum wage rise in the UK)
  - The scale of these businesses and the operational gearing they naturally possess means these reinvestments as promised are highly affordable
  - The same however cannot be said for all business models
  - Whilst on going ‘take’ such as this is far from ideal and we must be mindful of nationalising profits, looked at another way is it different from the sizable charitable donations that many Western corporations today make?

If you paid \$300 for Alibaba then such pay-outs may be part of the FCF that as you hoped to come your way. If paying \$160 a little leakage to ensure a favourable regulatory view and longer term stability is quite acceptable. Crucially with these or other policies there needs to be fairness and no favouritism inside an industry. This does look to be the case in policy changes so far which is perhaps different from when first only Jack Ma was targeted.

Interestingly the very scale economic model that we are attracted to gives an ability to ‘invest’ or ‘give away’ more, where perhaps less established new competitors cannot.

The same is also true of the changing of 996 culture (i.e. where internet company employees work from 9am-9pm 6 days a week). Change here must be accepted as a good development by all, both inside and outside China. But who is best able to afford better future working practices – the incumbent businesses most likely. And in most cases these costs can be passed onto customers.

#### Other observations

- The main characteristics of businesses remain despite policy changes i.e. online will still be a high growth area and largely capital light
- This is not about stealing the West’s money, but about making structural changes to the heart of the Chinese economy for its longer term improvement (Hayden)
- Mega-cap shares can sometimes be mispriced (RV Capital). This is possible when a reinforced and echoing message is agreed by all/most market participants. That this occurs only occasionally in large well analysed companies we of course accept. However our contrarian investing approach and efforts to understand investor’s psychological biases give us a few past examples. J P Morgan looked like one of those in 2014-16. Maybe Alibaba is one today.

#### In closing

This is not a research piece on Alibaba. But one to reflect on other investors reactions and biases to the investment opportunity that may present itself today in China.

In terms of how best to deploy capital in this region we should accept that others have greater skill and a wider circle of competence than us. However we retain the views expressed in our earlier Alibaba piece. Namely:

- That we like the power of a scale economy model that already has such huge reach
- That such a company can be bought for a PEG of below 0.5x vs 2x in Western markets is hugely appealing

That the risks associated with the company have changed since we published in June we will accept, that they have worsened we are not so sure (less vengeance towards \$BABA/Jack Ma vs more country risk). However better capital cycle outcomes vs competitors. We are also more than aware of other risks/events emerging (Evergrade).

Put us down as contrarian bulls of China, when the price is right. Alibaba we think is a good way for non-locals to participate.

**Andrew**

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