SHORT BRIEFINGS ON LONG TERM THINKING – EPISODE 15

THE GREAT DIVERGENCE BETWEEN EAST AND WEST

MB – Malcolm Borthwick

RS – Roddy Snell

MB Hello and welcome to Short Briefings on Long Term Thinking. Thanks for joining us. I'm Malcolm Borthwick, managing editor of Intellectual Capital at Baillie Gifford.

China's economy is one of the few to have avoided recession this year. In the second quarter of 2020, it grew by 3 per cent compared to the same period last year. In contrast, the US economy shrank by 33 per cent. Well, that's a short-term snapshot, but how will the pandemic shape growth and investing over the next decade?

I'm joined by Roddy Snell, co-manager of the new Baillie Gifford China Growth Trust, Baillie Gifford's China Fund, and Baillie Gifford's Pacific Fund. Roddy is also deputy manager of the Pacific Horizon Investment Trust.

But before we start the podcast, some important information. Please remember that as with all investments, your capital is at risk and your income is not guaranteed. And this podcast has been recorded during the Coronavirus pandemic, so Roddy and I are both at home as opposed to in the usual Edinburgh studio.

Roddy, welcome, and you joined us for our very first podcast in January 2019, so it's great to have you back. Firstly, what impact has the crisis had on Chinese companies?

RS It's good to be back, Malcolm, and thank you for that introduction. China has had a severe contraction and downturn, but it's bounced back very quickly, and I'd say things are pretty much back to normal.

An enduring feature of this crisis, for the companies we look at, is probably that the strong have got stronger. We've seen that in traditional companies in industrial areas, like CATL the battery maker that we own. A number of their competitors have gone out of business. They've taken market share, and I think we're going to see super-normal profits for a few years going forward. And also in the tech space, where we've seen a surge of users, which has allowed businesses to scale up far more rapidly than they would have done - businesses like Meituan, the online food delivery business. As an example, their grocery business, which is relatively new, saw an increase of 400 per cent in terms of users over the crisis period.

MB Give me an idea of what the situation is like on the ground in China in terms of the economy compared to say the UK or US.

RS I think we are heading back towards normality in China. If you look at all the key macro datapoints, we're essentially back to a decent economy that should be growing at a 5-to-6 per cent growth rate. Air travel, for example, is back to 2019 levels in terms of domestic travel. Auto sales have picked up nicely, particularly luxury sales. They're probably 10-to-20 per cent higher than they were this time last year. So, in all intents and purposes, China is back to business and up and running.

MB Both China and the west have taken very different approaches during the crisis. Western governments have injected huge amounts of money into the economy, something China has avoided. Which model do you think is likely to be most successful?

RS That's an interesting question. I think, over the next ten years, we're probably at an inflection point where we're going to see a real divergence between countries that handled the crisis well, like China, that haven't massively expanded their balance sheets, and those that have, which I would say would be the developed west. And I think it's going to have profound consequences.

You look around today, as an investor, and you say, "there's trillions of dollars of liquidity in the world today, where do I want to invest?" Is it countries in the debt-laden west, who have expanded their balance sheets by trillions during this crisis, have told us quite clearly that zero or negative interest rates are here to stay, and have very little growth? Or is it countries like China, with decent structural growth rates, that haven't blown up their balance sheets and have sensible interest rates? I think it's probably very clearly the latter, in which case it's a very exciting time for China. And as I say, it's perhaps an inflection point where a lot of capital starts to look east.

MB And one of the questions I often ask investors in the podcasts, particularly lately, is "what has the crisis changed your mind about"?

RS Sure. Perhaps my answer is a little bit surprising, but maybe not that much. If you look at our portfolio, which is, I suppose, where we express our actual views, we haven't changed it that much.

I think that's because the crisis has really accelerated the changes that we saw happening over the next 10-to-15 years. For example, we can look at one of our holdings, Ping An Good Doctor, which is an online GP surgery, where GPs can review about 500 patients a day with double the accuracy of a normal doctor. The crisis has accelerated the adoption of people moving online to visit their doctor.

Much like SARS back in 2003, which was the catalyst for ecommerce in China, you're seeing, across other parts of technology in the country, a permanent shift online - in areas such as GP services, doctors, and food delivery. So, the change we're seeing, and what has changed my mind, is the speed and acceleration of adoption in China. That's probably the enduring feature.

MB And what about the future? In a recent paper you say that China is the most exciting market to invest in, in the coming decades. Why is that?

RS Sure, I think there are a few reasons. First, if you take the big picture, China is just too big to ignore. It's got the largest middle class in the world, the second largest economy, and there's a lot more to come. China is going to be growing at 5-to-6 per cent for the foreseeable future, which is the envy, I think, of many western economies. And it's really under-owned. It counts for about 18 per cent of global market cap, 30 per cent of listed stocks, yet just 2.5 per cent of global funds. So, there's a big anomaly that investors can get ahead of.

Perhaps more importantly for us, in terms of managing the portfolio, at the stock level there's some great opportunities. As we've already covered, China has many world-class companies, and some of the most innovative companies, I'd argue, in the world. Crucially, it's a market you can add a lot of value in as an active investor. It really is incredibly inefficient. If you look at our Emerging Markets Team, which has been around for more than 25 years, we've added most of our value, consistently, in China, and that is because of the inefficiency there. It's very retail driven. The average holding period is often less than 50 days. That means if you have a long-term time horizon, 5-to-10 years, you really do have a differentiated edge in the country.

MB Trade relations between China and the US are at their lowest in decades. What do you think this means for the long term in relation to investing in China?

RS Firstly, I think it's inevitable that tensions are going to rise between the two countries. I think it's a natural consequence of having a superpower and new superpower arising. However, my view is that it probably makes China stronger in the future. If you go back to Napoleon, he once said that: "China is a sleeping giant; let her sleep for when she wakes, she will shake the world". I think what the US has done with this provocation is, essentially, awaken the sleeping giant.

And that is, actually, a good thing for China. Having some competition, someone breathing down your neck, is usually a good thing. You're seeing China now double down on everything from innovation and technology and research and development (R&D) to make sure that it is fully self-sufficient and able to compete on a global scale.

I think in the long run, China is the winner from the issues that we see with the US today. And there are certainly a number of stocks that should benefit from that.

MB When we talked a couple of years ago, we talked about it more as a trade war. But it seems to really be more of a tech war now, in terms of what we've seen with Huawei and ByteDance, the owners of TikTok.

RS I think that's a very accurate description. It's definitely moved towards technology as the pinch point. And I suppose that's inevitable, given that technology really is the future of many economies, and ultimately, power in the world over the coming decades. I think there are areas that will be, from an investment perspective, hit hard.

Specific companies such as Huawei, maybe even ZTE, which is also of Oracle and Microsoft.

And a second theme, which plays a little bit into this, I think, is increasing Chinese nationalism. A lot of Chinese, particularly the young, want to go for local national brands as opposed to western. For example, we're invested in Li-Ning, which is a sportswear maker, a bit like Nike. We're seeing, particularly the under 30s, shift away from Nike and Adidas towards companies like Li-Ning. So, there's going to be volatility in the market but lots of opportunities for stock pickers.

MB It's interesting listening to the ex-Google boss Eric Schmidt, in an interview recently, where he was talking about the fact that the US had dropped the ball in terms of innovation, saying that China had caught up or was catching up. But I wonder if the picture is more that China, in terms of innovation and research and development, hasn't just caught up but has maybe overtaken the US.

RS That's a very interesting point. There are several ways of looking at that. I think, if you just look at pure R&D spending, China now spends more than Europe and is catching up, or will have already caught up, with the US. It certainly files more patents. In terms of big picture, it's doing everything it can, and may well already be ahead of the US. And certainly, at a company level, in specific areas, I would say that China is certainly leading the way.

If you look at ecommerce, companies like Alibaba and JD.com have created by far the largest ecommerce market in the world. It's larger than the next 10 largest ecommerce markets in the world today, more than double the size of the US ecommerce market. In areas like batteries and electric vehicles, China now dominates.

About half of all electric vehicles are now in the Chinese market, and they have a huge aspiration to get to 25 per cent of all cars being electric vehicles within the next five years. I certainly think, in terms of R&D and innovation, they're spending as much if not more than the US, and in certain areas, they are leaders, particularly online and mobile.

MB We're recording this podcast at home at the moment. A lot of people are working from home. Has that changed your approach to work and how you invest?

RS In some ways, not too much. For 110 years plus, Baillie Gifford has only ever been based in Edinburgh, where we've researched companies from afar, with occasional trips out to the regions. In many ways, day-to-day, things haven't changed. And with technology, it's actually easier to meet management than it ever has been. This week I've had meetings with at least eight Chinese companies already.

I suppose the bit I miss is travel. I think you can get away without it for a period, but ultimately it does ebb away at some of the insights. I do enjoy getting out to China and the region and spending time with management teams, competitors, and experiencing a bit of serendipity. You don't necessarily know what you're going to find, but it can often be useful.

I think, for a period, it doesn't really matter, but ultimately, after 12 months, not being able to go to the region occasionally is something that I would miss from an investment perspective.

MB Roddy, you mentioned serendipity and the importance of being in a country and travelling to do your research. Is there an example that you can think of where serendipity has led to an investment opportunity?

RS Sure, there's quite a few. One that springs to mind, from a previous trip, was getting stuck in a traffic jam in Shanghai outside a Li-Ning store, which as we mentioned, is the Nike or Adidas of China. This is a company that had done very well for many years, but then they'd fallen on hard times. The key founder stopped being involved, they got the brands wrong, and I'd considered it as a sort of dead company, if you like.

However, being stuck in this traffic jam outside one of their leading stores in Shanghai, I saw queues going around the block for one of their latest trainer designs. And it sprung a thought in my head that perhaps fortunes had turned around at Li-Ning. Given the operational gearing you see in fashion brands, that could be quite an exciting time to start revisiting the story. That was really the catalyst for starting to look at it again in a little bit more detail.

MB And Li-Ning is run by a famous Chinese Olympic gymnast.

RS That's right. Mr Li Ning was very good in his day. I think he won three gold medals at the Los Angeles Olympics.

MB Well, let's end it there Roddy. Thanks very much for joining us on the podcast.

RS Yes, thank you very much

MB You can find our podcast Short Briefings on Long Term Thinking at BaillieGifford.com/podcasts, and subscribe at Apple Podcasts, Spotify and TuneIn. And if you enjoyed the podcast, please spread the word.

And many thanks to Lord of the Isles for the music. The track we've used is called Horizon Effect, which was released on Permanent Vacation. And if you're listening at home, stay well, and we look forward to bringing us more insights in our next podcast.

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