Baillie Gifford™

Why growth investors can’t ignore China

October 2024

Short Briefings on Long Term Thinking – Episode 42

Leo Kelion (LK): Have you heard of EREVs, extended-range electric vehicles? They're the fastest-growing segment in China, the world's biggest electric vehicle market. The cars have a small combustion engine, but unlike traditional hybrids, all it does is recharge the battery when it's low. That means they use less petrol on daily commutes but can drive over 700 miles, so forget about range anxiety. The innovation recently helped China's sales of new energy vehicles overtake conventional models for the first time. Yet as fast as demand is rising, it's outpaced by production, and unsold EVs are piling up in some parking lots. However, as we'll discover, that may be no bad thing.

Welcome to Short Briefings on Long-Term Thinking. I'm Leo Kelion, and I'm joined by Helen Xiong, one of the investment managers in our Global Alpha team. Helen's also a partner in Baillie Gifford, and recently became joint deputy manager of the Monks Investment Trust.

In this podcast, we'll discuss China's advanced manufacturing sector, the issue of overcapacity, and more broadly, why the country matters to all long-term investors. But first, a quick reminder. As with all investments, your capital is at risk, and your income is not guaranteed.

Helen, welcome to the podcast.

Helen Xiong (HX): Thank you, Leo.

LK: I want to return to the issue of overcapacity in a minute. But since this is your first time on the show, can you start by telling us a bit about yourself and specifically the perspective you bring to seeking out growth in China?

HX: Yes, so I was born in China. Both my parents are Chinese, but I only lived there for the first six years of my life. I moved to South Africa when I was six. This was in the early 90s when South Africa was going through this extraordinary historic transition from apartheid to democracy. And I left South Africa when I was 16 and have been in Europe ever since.

So when people ask me where I'm from, I really struggle with that answer because I feel in equal parts European, African and Chinese. I speak Chinese to my parents and English to my kids. But to your question on perspectives, I think if there's any advantage of being a European-African-Chinese is that I have more of a cultural context. So I think often when we look at things that are foreign to us, we place our own mental models and frameworks. And we don't always realise how those mental models and frameworks are affected by our cultural context, which carries sometimes some biases. And I guess I'm as biased as everyone else, but I'm more aware of some of those biases.

LK: Can you give me an example of that? Because often in China, you need to look at things over a long time span to make sense of them, don't you?

Yes, there are several examples that we could go down here, but I think the most fundamental one is how the different cultures think about moral psychology. So I think in the west, we are a very individualistic society. When we see the world, we see the world of individuals. So a lot of our moral philosophy is about protecting individual rights. Whereas in China, they see a world of relationships between families, between institutions and between society.

So their morality is less about rights but more about virtues that bind those relationships together. So things like filial duty, respect for your elders, hierarchy. So it's a more nuanced, a more holistic and pluralistic view of society.

And I think viewed in that light, many policies that may seem offensive to us may not be in the eyes of the Chinese. And to give you a concrete example, both my grandparents had a lot of children. My father was one in six and my mother was one of five. And I remember when I asked my grandmother when I was very young on why she decided to have so many children, her answer was very simply: well, the government was encouraging population growth.

And so this was in the 1950s, just after the Civil War, where Mao Zedong was really trying to encourage population growth as it brought strength to the country. But to us, it's almost inconceivable that we would plan our families around what the government has asked us to do. But I think my grandparents thought that they were being good patriotic citizens.

LK: So does that feed into how you're looking at investment opportunities in China, particularly at the moment after we've had some of the weak economic data that came out after Covid?

HX: Yes, and I think there's lots of different ways to view the weak economic data, but we have to be careful to separate the cyclical from the structural.

I think on the cyclical side, you know, China has just not had an economic recovery post-Covid in the same way that a lot of the western economies had. Property prices is one of the reasons for that. So 70 per cent of Chinese consumer wealth is tied into property. So when your property falls by 10 or 20 per cent, that has a real impact on people and how willing they're feeling and how wealthy they're feeling.

I think on the more structural side, China is transitioning from a property-led economy to an advanced manufacturing economy, and that is a very choreographed move. They've been doing it for years, and it's going to have some short-term consequences for it. These phase transitions aren't always smooth, but they've done it many times before.

In the 1990s, China's economy was mostly about export manufacturing. And then you go on to the 2010s, where it was mostly about housing and property building. And I think what they're trying to do is to lay the foundations for advanced manufacturing. And so China is trying to move away from sort of the low-value sectors of property into the higher-value and ultimately higher-return sectors as well.

LK: Before we dive into the detail, I mentioned in the introduction that your focus at Baillie Gifford is Global Alpha and Monks, and you manage diversified portfolios, of which Chinese stocks are a relatively small part. So why are we talking about China today?

HX: You're right, I manage a globally diversified portfolio, and Chinese companies is a tiny part of that portfolio. But you know, I think we live in a world today where China is just so intricately connected to the rest of the world, in that our global supply chains depend on China.

I think our green energy transition would not be possible without China. And most of the western companies that we own rely on China as one of the largest markets. And I think China is important not just for its economic influence, but diplomatic influence, particularly in Asia. And it's home to some of the leading technology companies in the world as well. So I think as a global investor, even if you choose not to invest directly in Chinese companies, you can't ignore China, because you can't understand the world without understanding China.

LK: So this is the idea that even if you're only investing in companies outside China, what happens in China can affect them?

HX: Yes, I think even if you're just a US investor, you would still have a very keen interest in China.

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LK: So you recently published a paper, *China finding the new shoots of growth*. And in it, you suggested that overcapacity in the electric car and other advanced manufacturing sectors is a feature rather than a bug in China. Can you explain what you meant by that?

HX: Yes, I think when I speak to a lot of investors on some of the Chinese industrial sectors, they all worry about overcapacity. And hence, they tend to ignore those sectors. But I think a lot of that is down to some misunderstanding. Specifically, I think timeframes matter. So those who are worrying about overcapacity are only concerned about the short term. Whereas I think the Chinese policymakers are not looking at the short term, they're looking at what this industry might need five to 10 years from now and building for that.

The second thing I would say is overcapacity is a risk for a lot of mature industries, but for newer industries like electric vehicles, where we can be pretty sure that the cost of manufacturing, the cost of production falls as the production grows because it follows very predictable learning curves, that it's less of a risk because you can map out the demand for that. As you grow production, cost falls, which means price comes down and people demand more. In fact, it's more of an opportunity because if you're the first one to scale your production you're going to have all of those learnings and IP from efficiency gains etc that you're going to be able to use and build up your competitive advantage.

LK: And you said IP, that's intellectual property, right?

HX: Yes, that's right.

LK: So if the idea is that if Chinese car makers can get better and more efficient and make the cars at a cheaper cost by making more of them, presumably you can't do that forever. Overcapacity has got to be time-limited, does it?

HX: It is. And eventually I think market forces take over. So China is one of the most brutally competitive markets in the world, and initially all of these new EV companies would get a lot of support, but eventually the poor ones are out-competed by the more efficient, more innovative players, and you start to get market consolidation.

LK: And you're invested in one of those car makers, Li Auto. It stands out because I think there's only three car makers, three electric vehicle makers globally that are making these vehicles at a profit. And it's one of those. What distinguishes it from its rivals?

HX: If you look at even five years ago in China, electric vehicle penetration was very, very low. It was about five per cent. And that's despite over a decade of very supportive supply-side policies. And just to put that into perspective, do you want to guess what that penetration rate is today, five years on?

LK: Is it 30 per cent or something like that?

HX: It's about 50 per cent.

LK: 50?

HX: So it's had really explosive growth. But the reason why it was so low five years ago was because of range anxiety and price. And a lot of the EV makers either didn't really have a good answer to that or didn't really try to solve that problem, or solved it with battery swaps, where you can drive into a station, they would swap your battery in three minutes. But the problem with the battery-swap solution is that it's very, very expensive. The battery is the most expensive part of the vehicle, and if you had to have more than one battery for every vehicle that you sold, it's going to make the price of the vehicles more expensive, which meant it's going to be a very small market.

And Li Auto really pioneered a new solution to that, which as you said is the EREVs, where they put a small combustion engine in the vehicle. The sole purpose of that combustion engine is to charge the battery, so you get around the range anxiety because you can carry a full tank of petrol that charges the battery when it's depleted, but also you can put less battery in your vehicle to achieve a much greater range.

So the cars were cheaper to make. And so you were getting an electric vehicle effectively for the same price as an internal combustion engine.

And then the second part is just, I think a lot of the newer companies who were trying to do electric vehicles all had a software background and didn't really lean into the cost efficiency, the manufacturing side of it, because ultimately this is a manufacturing business, it's a low-margin business.

And I think that's what Li Auto really got right. So Li Xiang, the founder, this is not his first business. In his first business, which is also listed, the business almost went bankrupt. And it had to be rescued, but he was diluted and effectively sort of pushed out of the business and he didn't want this to happen to him again. So they raised very, very little money. They focused on cost efficiency. And I think because of their business model as well, when they went for the EREV, it was more cost-efficient and capital efficient than all of the others. And they got to profitability at a much smaller scale than any other company.

LK: Have you met him? And if so, what's he like?

HX: I have. One of the differences I would point out is just the extreme attention to detail. And that's one of the things that I think he has in common with a lot of the best founders is they would be able to tell you exactly why they've made this decision and how much every part costs, etc.

So one of the examples I think would be, they said, we decided not to have fast acceleration in our vehicles because that saved us 30,000 RMB per vehicle. And we understood that most of the buyers of our vehicles are family buyers. So that is not important to them.

LK: That's about £3,500 or so. Just because we don’t have these cars over here, I think you've test-driven one of them. Can you give us an idea of what they're like? Because it's a premium feel when you're in it, isn't it?

HX: It's definitely a premium product. It sells for more than the Tesla Model Ys in China. You know, it's interesting. I've spoken to many EV car companies about their companies, and everyone in China now talks about the iPhone moment. And by that, they mean that these cars are going to be to the automotive sector what the iPhone was to mobile phones. And I don't think I fully internalised that until I sat in one of the cars and test-drove it for myself.

The experience is, it's difficult to describe, it's like the wow moments that you get. The whole vehicle is voice-controlled. If I ask the vehicle to turn on my back massage, the vehicle would understand where that sound is coming from and turn on only my back massage.

LK: Wow.

HX: In the back seat, there is entertainment. So there's a big screen that comes down, and that can be controlled either with your voice or hand gestures. So you can wave your hand around and open and close your hand to control that. And there's a mini fridge at the back. So I think the car is moving away from a functional utility that takes you from A to B to more of a place of entertainment and relaxation.

LK: So we've discussed electric vehicles as an example of an investable opportunity in China, but we can't talk about China without addressing regulatory risk. And it's a fact that we're seeing even tougher trade restrictions being introduced against some Chinese companies. For instance, with the electric vehicles we were just talking about. In the US recently raised import duties on Chinese EVs to 100 per cent and I think the lithium-ion batteries they depend on to about 25 per cent and that's got to be quite a significant deterrent to buying them. How do you factor that dynamic into your investment thinking?

HX: So I think raising trade barriers is an inevitability. So you can't eliminate the risk, you have to manage it. People think you can manage it by avoiding Chinese companies, but that is misguided. Europe exports a lot of luxury cars and luxury products to China. A lot of American companies sell a lot of things into the Chinese market. So I think there is a risk of retaliation as well.

And secondly, I'd say that a lot of Chinese companies don't actually rely on selling anything to the west. For example, Li Auto that we just discussed is mostly a domestic story. And for electric vehicles right now, China is about 60 per cent of the global market. So China is the biggest market.

And then I think you get other companies like CATL, which is the largest battery maker in the world with 37 per cent global market share. They do sell to Europe, but they also manufacture in Europe, so they are the largest battery maker in Europe. They've got plants in Hungary and Germany, so a lot of the import restrictions won't apply to them.

But ultimately, I think manufacturing in Europe is more expensive. It costs about 40 per cent more to make a car in Europe than it does in China. And we as a society will have to make a decision on whether we're happy to pay that cost and risk delaying our green energy transition or whether we accept that China has a role to play in it.

LK: And you mentioned retaliation against western companies. Does that affect the companies that you invest in or maybe decisions to sell? Have there been examples where you've sold out of holdings because there's a fear that China could retaliate?

HX: Well I wouldn't say that the fear that China could retaliate has been the only reason why we sold some of those companies, but I think the way we manage the geopolitical and regulatory risk in the portfolio is twofold.

The first is we have been moving away from companies where cross-border trade is one of the main drivers of the investment case. So we've reduced or sold out of companies like Estée Lauder, Adidas, Pernod Ricard, and we have tended to favour companies where it's local for local.

And secondly, where we do invest in China, we want to invest in sectors that are aligned with the broader strategic priorities. So more in the areas of advanced manufacturing, like batteries and electric vehicles and less in areas where I think there is at risk of more regulation, like banking and property, for example.

LK: That's interesting because a few years ago we saw the Chinese regulators impose fines and restrictions on some of the big Chinese internet companies. Is the idea that you think that's much less likely against those involved in advanced manufacturing?

HX: I wouldn't ever say never, but I think as long as the companies in the advanced manufacturing sectors behave themselves and operate and contribute to society, I do think it's less likely. I think we have to remember as well a lot of the regulations that we saw in the internet companies, it was because the internet companies weren't behaving well in that the regulation asked them to protect consumer data, it asked them – you know, you can't enforce exclusivity on your suppliers. So, I think it was good regulation that any good government would take.

LK: In recent weeks, China's announced wide-ranging stimulus from cheaper interest rates, making it easier for firms to buy back shares, measures to encourage mergers and acquisitions, and there's rumours of further fiscal stimulus to come. As a long-term investor, how does that affect your thinking about the companies in your portfolio and those that you might buy?

HX: Yes, I think everyone is very excited about the fiscal stimulus and the pro-growth measures to support the property sector and give handouts to consumers. It's helpful at the margin for Chinese sentiment and the share prices of a lot of the Chinese companies have bounced really strongly. But it's short term and it's not going to change the fundamentals of businesses.

The ones that I'm more interested in are some of the announcements that I think have been buried among all of the stimulus, which are more announcements on encouraging M&A or encouraging companies to pay back more cash to shareholders and I'm wondering if that is policymakers trying to take a leaf out of the Tokyo Stock Exchange and what they've been doing on the corporate governance reforms in Japan there. But I think it's probably too early to tell.

LK: And in Japan, it's about trying to make sure that the management of companies are more focused on what's in the shareholders' interest, right?

HX: That's right. So in the last four years, there's been a series of corporate governance reforms in Japan where historically Japanese companies have held a lot of cash on the balance sheet and they've not really cared about shareholder returns. And I think a lot of the corporate governance reforms are about them raising the standard and almost forcing them to care more about shareholder returns. So a lot of the valuations of Japanese companies have gone up quite significantly.

LK: It'll be fascinating to see if we see something similar play out in China, as you suggest. It's been great talking to you, Helen. Before you go, we like to ask our guests what book they're reading or have recently finished that they might recommend. So what's new on your bookshelf?

HX: So the book I'm reading at the moment is called *The Righteous Mind* by Jonathan Haidt, and it's about moral psychology. And he makes the arguments that our moral judgments are based on intuition rather than reason, and reason comes second to justify that intuition, and that moral intuition differs very widely across the societies.

LK: That's interesting, the idea of moral reasoning coming from intuition, even though we don't realise it. I'm just wondering, is there something similar, do you think, that happens in investment? Does intuition play a role when you decide which companies to research or even buy?

HX: My reason wants to say no, but that may just be my reason trying to justify my intuition. I think when it comes to moral judgments, there's a lot of evolutionary reasons why we rely on intuition. I think when it comes to analysing companies, you always want to approach it from a beginner's mindset and always ask even things that you think are obvious, never assume that it's obvious and always ask the why questions.

But over time, a lot of what we do is about pattern recognition and intuition plays a part. I'd like to think that it's more reason, but I don't know if that's just justifying my intuition.

LK: I guess it's hard to ever know. Helen, thank you so much for coming on. It's been great to talk to you.

HX: Thank you, Leo

LK: And thank you for joining us for this conversation. You can explore more of Helen's thinking on this topic in the paper we discussed, *China finding the new shoots of growth*, which we've linked to in our show notes. We've also linked to another of Helen's recent articles, *Beyond NVIDIA*, about investing in the chip industry, including some of its lesser-known champions, as well as highlighting where you can find out more about Li Auto and some of the other companies we discussed.

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Show notes

China is transitioning from a property-led economy to one focused on advanced manufacturing. It already leads the world in electric car production and the batteries that power them. And it's also a growing force in renewables, robotics and biotech. Investment manager Helen Xiong discusses some of the growth companies involved, why concerns about overcapacity seem overstated and why rising trade barriers have implications for stocks traded inside and outside China.

Background:
Helen Xiong is an investment manager in Baillie Gifford's Global Alpha Team and recently became joint deputy manager of The Monks Investment Trust. In this episode of S*hort Briefings on Long Term Thinking* she discusses why global growth investors can't ignore China even if they don't directly own stakes in any of its companies.

She describes how the country has made 'advanced manufacturing' a strategic priority, laying the foundations for future growth. This has already yielded results, with companies such as the electric vehicle maker Li Auto and battery producer CATL creating long-term value for shareholders – with the prospect of more to come.

Xiong suggests that 'rising trade barriers' are one consequence of Western nations' seeking to protect domestic industries and discusses how she takes this into account when deciding which companies to back. In addition, she considers the implications of Chinese retaliation and what that might mean for some of the US and Europe's leading exporters.
Xiong also shares her view on recent stimulus by the Chinese central bank and government agencies, focusing on signals of a shift that could create long-term shareholder value.

Resources:
China: finding the new shoots of growth
Jonathan Haidt: *The Righteous Mind – Why Good People are Divided by Politics and Religion*

More from Helen Xiong:
Beyond NVIDIA: investing across the semiconductor ecosystem
Global Alpha Investor Forum 2024

Companies mentioned include:
Li Auto
CATL

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Risk factors

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