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EP92 | Intensifying regulatory risk in China

Rob Campbell: 00:22 This episode is one where the disclaimer we're about to hear is an important place to start. Views expressed are based on the information available at the time and subject to change.

00:32 In the conversation that follows, Peter Lampert and I talk through a real time scenario in risk management related to the regulatory intensity currently impacting businesses and stock prices in China. Though our international and emerging markets portfolios haven't been immune from some of the downdrafts, the funds have actually weathered the storm pretty well so far. And as Peter explains, this is because the risk management was done beforehand. Both through the way that we had sized individual positions, and in how we've managed aggregate exposures across the portfolios.

01:03 I came away from the conversation with a better understanding of what's currently happening in China, as well as how our investment process deals with uncertainty across a number of levels—in terms of the outlooks for individual businesses, for the portfolio as a whole, but also for the behavioural elements at play that can impact our decision making in real time.

Hope you all get as much out of this episode as I did. Enjoy.

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Rob Campbell: 01:46 Welcome back to the podcast, Peter. I know you were just on to talk about emerging markets and we've roped you back in, just given some of the action that we're seeing in the asset class. So, welcome back.

Peter Lampert: 01:56 Yeah, there's certainly lots going on.

Rob Campbell: 01:58 Well, I presume that just emerging markets...it's sort of an exciting asset class. It's got to be part of the draw in terms of potential returns, but some of the risks play out as well, and so can you tell us a little bit about what's happening in China right now?

Peter Lampert: 02:10 The Chinese government has been increasing the regulatory pressure on a wide range of businesses in China and we are seeing the impact in the stock market. There's been a broad sell-off in Chinese stocks since they peaked earlier this year in February. And as we record this today, August 16th, Chinese stocks have been really beaten up, and especially the ones that are seen to have the most to lose from any potential regulatory changes.

Rob Campbell: 02:35 Is this when this really began? Back in February of this year?

Peter Lampert: 02:38 It's been going on for longer. It's no secret that the Chinese government is more involved in the economy and there's always a higher degree of regulatory risk, but this current round of regulatory scrutiny, I think, really kicked off last November when the Ant [Group, formerly Ant Financial] IPO was halted. That was a very high profile IPO; it was going to be one of the largest IPOs ever. And regulators stepped in with concerns about the business and ultimately halted the business model, showing investors that they would be taking a more heavy-handed approach to regulations. Since then, they've taken a number of other actions to other businesses and industries, and this has continued on until today.

Rob Campbell: 03:16 That's been my observation—[that] back with the Ant [Group] IPO, it seemed very focused on Alibaba, potentially Jack Ma, and his relationship with the government, and it does seem to have broadened since then. I don't know if that's by design or that's just the way it's played out.

Peter Lampert: 03:30 Yeah, definitely. I think at that time there was a lot of discussion: is Jack Ma as an individual being singled out, or is this a broader issue? Now it's quite clear today that it's a much broader issue, and Alibaba and Jack Ma are just one of many imbalances, I think, that the Chinese government sees a need to address.

Rob Campbell: 03:47 Can you elaborate on those imbalances? What's motivating the government's actions?

Peter Lampert: 03:51 I think ultimately the government's aim is to make China a better place for most Chinese people and to improve the lives of most Chinese people. And to do that, they want to have more social stability, improve living conditions for people, and that should in turn allow the CCP to maintain political control. So I think those two aims go hand in hand: with more political control they can help achieve social stability, and with more social stability, they can maintain political control.

04:19 So there's a lot of issues right now, and these imbalances have been sort of allowed to get out of hand with rising costs of living, declining birth rates, the wealth gap or income inequality rising, the dominance of internet companies and the lack of competition and the impact that that has on consumers…

So [for] all of these, the government has sort of turned a blind eye and allowed them to run, but now it's at a point where I think the government feels that they have enough political control to take on some of these invested interests. They're able to do that. And the economy is healthy enough that if there is any negative repercussions that it can get through it. So now I think they've identified a window here where they can address a lot of these imbalances that have been allowed to grow.

And they've been clear, in that the government has said they expect over the next six months to have quite broad sweeping regulatory reforms over a wide number of industries.

Rob Campbell: 05:14 It's interesting—when you mentioned that list of imbalances, sort of going through them and thinking: are things that different in the West? What is different about China in this case?

Peter Lampert: 05:23 Certainly a lot of countries face similar issues. The unique system of the Chinese government gives them a lot of ability to tackle these issues if they choose to do so. So, it's not so easy. I know some people have the view that China is very authoritarian and the government can do whatever it wants. I think, within the party, there are still many factions and there's still many strong vested interests across China, so it's not one person making all the decisions. Although there's some thoughts that it's moving more towards that direction. But generally, it is a more efficient line of command and control and [they're] able to move faster when they decide to make some of these regulatory changes.

Rob Campbell: 06:03 You mentioned starting with Alibaba, the Ant [Group] IPO—what companies have been impacted the most so far? Are they companies like Alibaba? These platform businesses? Or has it gone beyond that?

Peter Lampert:	**06:13**	Yeah, there's been a lot of scrutiny and focus on the entire internet sector, so companies like Alibaba and Tencent that have very dominant positions, and how they use those positions, how they use their data. We're still waiting; there haven't been a lot of new regulations there, but Ant [Group] and the lending business has certainly new regulations have come out there. DiDi had another high-profile IPO, and new regulations came out around how they can use their data. The education companies, one of which we invest in—New Oriental [Education and Technology Group]—which provide[s] afterschool tutoring…that was the most disruptive and severe regulatory change to negatively impact those businesses, essentially banning for-profit tutoring business. Next up, the government is looking at the property industry and healthcare. So in property, cracking down on a lot of that speculative activity that has driven up the cost of living, and healthcare, trying to improve the cost and quality for people.
Rob Campbell:	**07:11**	What's sort of the calculus that the Chinese government has in this? How dependent is China on foreign investors and that capital? Put differently, how much would something like turning the afterschool tutoring business into a not-for-profit industry… What kind of ramifications does that have for China and capital markets going forward?
Peter Lampert:	**07:31**	Yeah, it's definitely a negative card. And all investors, including ourselves, are looking at this thinking that the risks are increasing in China to the extent that there's more regulatory interference on for-profit businesses that makes it a less attractive place to invest. Or, we just assign higher levels of risk and require higher expected returns to invest there. So, certainly investors are speaking with their actions, selling off Chinese stocks to reflect that. I think the government, from what I've heard, has been surprised by the reaction—that investors haven't seen this as an isolated event for the tutoring business, but are taking a more broad view and concerned about overall investment in China.
Rob Campbell:	**08:08**	So maybe that's a good segue—I know you mentioned New Oriental, we mentioned Alibaba, how are you seeing the exposures within the various portfolios that you manage and how are you defining them?

Peter Lampert:	**08:20**	At Mawer, we have two portfolios that invest in China. Firstly, our emerging markets portfolio, which has 27% weight in China. And secondly, our international equity portfolio, which has a 9% weight in China. So, across our other portfolios we don't have any direct investments in Chinese companies. Whether that's Global Equity or Global Small Cap, EAFE Large Cap. So on a look-through basis, our end clients don't have a lot of exposure to China. Our typical client that has a diversified portfolio, such as invested in our Balanced Fund, would have about 2% exposure to China. So this is a material...what's happening in China is very meaningful for the Chinese stock market and all Chinese companies, but to put that in perspective, it's still part of a very diversified portfolio, at least for our clients at Mawer.
Rob Campbell:	**09:10**	What proportion of our China exposure is characterized by these types of stocks that might be subject to more scrutiny?
Peter Lampert:	**09:17**	I think when I look at our investments in China, about two-thirds of them I classify as being a more at risk of regulatory changes, and the other one-third not immune to risks, but in a lower risk bucket.
Rob Campbell:	**09:29**	So what have we been doing? Presumably some negative stock price charts in some of these investments. What's been the reaction? How has the process that we've talked about so much on this podcast historically...how has that played out real-time with respect to this bout of regulatory intensity in China?
Peter Lampert:	**09:46**	This is a real-time case study of our risk management process. Risk management is an important part of our process at Mawer, of our investment process. And it's a continuous process. It's something we do on an ongoing basis. So in all of these cases, in any investment, including in these Chinese stocks, the risk management is done when we initially make the investment. We analyze each stock on a risk-reward basis, stock by stock, and try to understand what the risks are, what the likely probabilities are of different scenarios unfolding, and whether the risk return is attractive. So that's the first step.

10:21 The second step is, once we have a number of stocks, looking for correlated risks. So in this case, a number of investments in China, clearly there are some correlated risks. They're all correlated to the health of the Chinese economy, the Chinese currency, political or government actions, or regulatory interference that can impact companies broadly. So, looking at those correlated risks and ring-fencing them within a weight. We set a weight that we think is reasonable. I talked about 9% is our current weight in international equity, 27% in emerging markets. Given the universe and the opportunity set, we think those are reasonable weights to accept these risks.

But the risk management is never done. It's an ongoing process. We're continuously evaluating new information that comes up and keeping an open mind and making sure we continue to process the new information and revisit our investment assumptions on an ongoing basis.

Rob Campbell: 11:16 Can you bring that to life maybe just with...I'm thinking about Tencent, which is a larger stock both within [the Mawer] International Equity and Emerging Markets [portfolios]. Like you said earlier, kind of peaked earlier this year and has been on a bit of a downward trend ever since. Obviously more volatile of late. How have you reacted to the news on that stock, and how have you adjusted its position size in the portfolio?

Peter Lampert: 11:34 Yes, that is our largest investment in China—Tencent. We think it's a fantastic business with a fantastic management team, but is facing some regulatory uncertainty in terms of how they can use their data, how they can monetize their data, and whether there'll be anti-competitive actions that would impact their profitability forward.

So far, the outcome has been that we've left the weight unchanged, we haven't added to or trimmed the position, but [that] doesn't mean to say we haven't done anything. We've been doing our homework, trying to reassess the odds, revisiting our valuation models. And if the business can remain mostly intact, we think we're getting a great business on sale and essentially a more attractive...or just a higher risk reward. There's more upside now at the current price, but we're taking on more risk.

Rob Campbell: 12:24 Is there any historical precedent for this sort of regulatory intervention, either in China, more broadly? And are there any lessons that you and the team have looked back on to try and figure out how to navigate through the current environment?

Peter Lampert: **12:36** I think given that the Chinese government is more involved in the economy and more involved in business than in many other countries, it's a double-edged sword. So there can be positive impacts, and certainly many of the companies that we invest in have enjoyed positive tailwinds from government actions in the past, and now some of them are facing some potential headwinds. So, I think that's important to keep in mind we have seen both the positives and negatives.

12:59 But in terms of on the negative side, there have been crackdowns. A couple of years ago, there was a crackdown on peer-to-peer lenders. A lot of startups were doing unregulated lending and entire businesses essentially got shut down or had to completely change their business. In that case, banks, incumbent banks, traditional banks, were a beneficiary, so there's a clear sort of winner and loser.

Peter Lampert: **13:19** In other times, there's crackdowns in a specific industry, so, often on pollution, whether it's steel mills, cement plants. The government's been trying to clean that up, close the small inefficient factories that pollute the most and benefit the larger companies that have newer plants and more efficient and [are] more environmentally friendly. And some of our investments like Conch Venture have benefitted from that.

13:43 But I think the difference in those past crackdowns is they were more industry specific, and there were sort of clear winners and losers. So if you understood the regulatory policy, you could try to align with the winners and invest in the beneficiaries. This one's a bit different in that it seems to be that we're looking at much more broadly sweeping reforms across many sectors, and we have yet to see that there will be clear winners. It could be that there are more losers across the board.

Rob Campbell: **14:11** Interesting. Obviously recognizing that this is real time, we're in the midst of this; the regulatory reviews, as you said, could last another six months...has this changed the way that you think about risk management, either in individual positions or within the portfolios overall?

Peter Lampert: **14:28** I think in terms of the specific risk of investing in China and Chinese businesses and the risk of negative regulatory actions, certainly we're trying to refine our odds, refine our assessments and probabilities, and the risks are increasing.

14:43 Taking a step back, in terms of our general approach to risk management, I think that's very robust and remains in place. And despite we've lost money on a number of Chinese stocks over the last six months, the process is working. I think we've sized the positions properly. New Oriental is one we talked about; that was only a 50-basis point position in our International Equity portfolio. So when the risks subsequently played out, the loss was mitigated. You see that in our performance, whether on an absolute or relative basis, our International Equity and Emerging Markets portfolios have held up pretty well this year. And certainly the rest of our portfolios, which have no exposure to China, are also doing quite well.

15:22 So, I think the process is robust. We have [a] clear risk management approach, and an important part of that is the team dynamic. That importantly remains intact as well. So a key to our investment approach and risk management is taking in different views from across the team and different perspectives. We highly value having that diverse team and gathering that different input. And that can lead to different decisions. We get recommendations. Right now, the debates and discussions we're having is whether we should be adding to some of these stocks, because they've been beaten up and the valuations are very attractive, or whether we should be selling them because the risks are increasing and the risk may be too high now.

Peter Lampert: 16:02 So we always are having those debates, and we ultimately translate that into portfolio decisions. And we may make different decisions. Like we've talked about, we've had some exposure in the International Equity and Emerging Markets portfolios, but we don't have any exposure in our Global Equity or Global Small Cap or other portfolios at Mawer because the assessment was that, for many reasons, different opportunity sets, but also the assessment is that the risks of investing in some of these Chinese companies are very high given the political and regulatory environment.

So we do consider all of these different elements and put them into practice and ultimately I think our clients are better off because of our robust risk management process and being in a diversified portfolio with our funds being a part of that.

Rob Campbell: 16:43 Peter, how conscious are you of behavioural biases? And specifically, something like loss aversion, where you've had some ideas, some of which like Tencent represent some of the largest positions in a portfolio, like you've elaborated on, lots of reasons to love these businesses, and for the stock to go against you over a shorter period of time? How do you deal with some of the more challenging behavioural aspects of that? Especially since the news flow is, or at least over the past month and a half, has been nonstop?

Peter Lampert: **17:11** Behavioural biases and errors [are] very important in investing. It's something we try to guard against as much as we can. We know we're all susceptible to making such errors.

17:19 A few things we do are trying to have a very consistent process. So having a clear process: we don't just buy and sell a stock based on the news headline. And when these types of events unfold, we go back. We revisit our DCF models, we revisit our assumptions, we revisit the different scenarios and plot that on The Matrix and see how these companies plot versus the other stocks in the portfolio and the rest of the opportunity set. So we have a systematic process to try to keep our emotions out of it and stick to the facts, stick to the logic, and make decisions based on our investment philosophy and process.

Peter Lampert: **17:54** We know we all have biases. The other thing, we try to be aware of them. We openly discuss that on the team, point those out. And we all tend to have sort of the same biases over time. So as long as I think we're aware of them and try to counterbalance them with the rest of the teammates that have different biases, that's helpful too.

18:13 Actually, the bias that I'm most concerned about at this instant is commitment bias. Just by coming on in a public setting like this, on a podcast, and openly talking about the investment decisions that we've made, there's a commitment bias possible that our future decisions then will get anchored to this. Your brain wants to be seen as being consistent with what you've said and done previously.

18:35 So, so far I said we haven't added to or trimmed our China weights, we think the market reaction has been fairly efficient in that the sell-off reflects the higher risk reward. We don't see an edge or an opportunity—whether on the buy side or the sell side. But we need to be open-minded and continuously reevaluate that, stay open to new information, continue to have these debates and discussions in our team, and not get anchored on that position.

So if I come onto a podcast next month and say the opposite thing, I won't be ashamed of that. I will be proud of that; that I didn't fall into the commitment bias. But all of these traps are minefields that we have to watch out for.

Rob Campbell: 19:14 That's so interesting, because we've always thought about the idea of...you write a research report, you write your thoughts down, the value in having a log of your thinking at any given point of time, historically, and just how important that can be—so that you have a proper recollection of what you were thinking at any given point of time. You're suggesting there's another side of that, which say you could get too married to that particular view and how important it is to stay flexible as things change.

Maybe to build on that and just a final question before we let you go, what would you need to see, one way or the other, in order to take action in the next couple of days, as you just said, or over the coming months? What sorts of things are you and the team looking for that might be more signal and that you might perceive as giving you edge?

Peter Lampert: 19:53 As I said previously, that this is a continuous process (investing and risk management), even when we're optically not doing anything by making trades, we're constantly evaluating new information and trying to filter out signal and noise. And when we do pick up on signal and we think we have an edge, and there's been a market inefficiency—whether there's either an opportunity to buy or sell—then we would act. But until then, we're happy to sit on our hands.

Rob Campbell: 20:19 All right. Well, Peter, that sounds like a good place to wrap. Thank you so much for coming back on the pod so soon after your last appearance. I can appreciate it's a really busy time for you and the team. Thanks again.

Peter Lampert: 20:29 Thanks, Rob.