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Growth Strategies

Reasons for exercising caution before investing in China

Be cautious of trends and fads. A recent article in the *Wall Street Journal* described two investment advisors that set up a subscription-based, newsletter regarding investing in China in their garage, having never visited China themselves.

Almost daily there are news articles about the investment excitement surrounding opportunities in China.

With one of the largest populations in the world, China's economic potential is difficult to ignore. Its fast-growing economy is demanding a larger share of the world's oil and steel production. Large initial public offerings of major industries controlled by the central government are being offered to attract foreign investment.

John Shao
Guest Column

Major U.S. companies like Home Depot and General Motors have invested in China's future with new facilities.

In this article I will outline my reasons for exercising caution before plunging into direct investments or mutual funds specializing in China securities.

While the overall picture for the Chinese economy is hopeful and exciting, challenges facing investors include:

- The Chinese stock market performance historically has been poor.
- In the past Chinese shares have tended to be introduced to the market at times of investor euphoria. Remember that the central government approves initial public offerings and politics are at the center of the selection of companies being offered, not competition. In a competitive environment, the shareholders receive the benefit of an IPO if it is successful, not the government.
- It is well known that most state-owned companies in the world are not well managed (there are many examples in Brazil and France). Most companies being offered from China are state-owned enterprises
- Chinese accounting practices are not completely reliable at this point. There is less regulatory protection in China and the courts are not independent, so the likelihood of a successful minority shareholder lawsuit is low. The U.S. corporate scandals a few years ago have ushered in a new level of corporate accountability in the United States. Foreign companies do not necessarily have to follow the same guidelines.
- Government-supported interest rates are at very low levels in order to attract investment. Profit margins are therefore very low for some industries and it is difficult to protect market share. For example, an official from Procter & Gamble China indicated last year that the company faces well over 100 competitive shampoo products in the country. State-owned enterprises as well as local entrepreneurs compete for market share.
- It is very difficult for capitalists to be successful in a market that is has considerable national, provincial and municipal government control which can influence and restrict management activities.

There are several fundamental investment lessons to take from China's example.

Finding good companies with a significant market share does not necessary mean the stock is a good investment. Good companies can mean many things including good customer service, good reputation, an employee-friendly company, and a good corporate citizen. However, a good stock investment means everything is right for the shareholders. The fact that the Chinese economy is growing strongly could mean more companies are in competition and not necessary that there are good stocks to be found.

Be cautious of trends and fads. A recent article in the *Wall Street Journal* described two investment advisors that set up a subscription-based newsletter regarding investing in China in their garage, having never visited China themselves.

If you must invest, do not do it directly. Buy a U.S. stock with potential for making money and whose risk you can assess that has a significantly expanding business or division in China and low competition from local companies.

Most international investing is high risk. Be very cautious with overseas companies. Make sure of your understanding of business, accounting, reliability and risk.

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