GMO

EMERGING THOUGHTS

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Ruminations on China and India

Arjun Divecha

***China**: If you build it, they will come…*

***India**: You're not going to build it, but they'll come anyway…*

It occurred to me that this is a good metaphor for China and India and the resulting implications for growth and investment return.

Last month I had a long chat with one of the people in China whose views I most respect. He is extremely plugged in with the financial elite and serves on a number of government advisory boards. He told a very convincing story about how things were going to play out in China over the next few years, and which sectors would benefit. However, at the end of the discussion, it occurred to me that the entirety of his story depended on government policy and actions.

In my travels around India over the last couple of weeks, I had multiple discussions with business and financial leaders about what is likely to happen in India over the next few years. None of their thoughts depended on government action. If anything, their main fear was that government intervention/inaction was the thing most likely to slow down or kill the huge growth momentum that exists today.

That, in a nutshell, is the relative case for China vs. India. China succeeds if the government gets it right; India succeeds if the government gets out of the way. Both could happen. Or neither. In both cases, long-term return to investors will depend not so much on the success or failure of the country in GDP terms, but on the ability of companies to deliver high return on capital. So, what drives return on capital?

One of my colleagues at GMO has written about the problems of overcapacity in China (see "China's Red Flags" by Edward Chancellor) so I won't spend time on it, but one thing is clear to me: building overcapacity is generally good for the consumer and bad for the producer. Thus, building multiple high-speed rail lines in China almost certainly improves the quality of life for the average Chinese, but it is inconceivable that the return on capital on those rail lines will be high, in pure financial terms. If it were, the U.S. would surely have built plenty of high-speed rail lines by now. After all, the ability of the U.S. consumer to pay for transportation is considerably higher than that of the Chinese consumer. The fact that no high-speed rail lines exist in the U.S. tells you something about the potential return on capital on high-speed rail in expansive continental geographies.

In short, overcapacity may lead to high social return, but almost certainly leads to low return on invested capital.

Now, let's look at India through this lens. In India (mainly due to poor government policy and implementation) everything is in short supply – too few roads, bridges, ports, educated people, etc. Thus, people have difficult lives, but it turns out that the average return on capital in corporate India is one of the highest of any country in the world (and has been for the last 10 years).

The one area in India that has overcapacity is mobile phones. And that's because it's the one policy the government actually got right – by allowing unfettered competition (and giving away 2G licenses for a song). As you may guess, none of the mobile phone companies are making much money because mobile rates are the lowest in the world. In fact, the largest mobile phone company is trying to grow profits by investing in telecoms outside of India.

This is what makes for the true irony of India – that bad policy has led to high profits because producers benefited from shortages.

Another interesting consequence of bad policy-making (India consistently runs high budget deficits) is the high cost of capital. This forces producers to invest only in high-return projects (so as to be above their cost of capital) and benefits investors by delivering high return on investment.

Now this sounds like a contradiction for investors like us – is it possible that investing in India benefits from bad policy in the long run? And, if so, should we not invest heavily in countries that have bad governments rather than good ones? Or, maybe one should focus on countries where the local cost of capital is high? Brazil is another high-cost-of-capital country that has produced high dollar returns despite mediocre economic growth.

I believe that sooner or later, the lack of infrastructure/education will start to bite and constrain India's ability to grow. We already see inflation picking up in India, as rising incomes are not matched by rising food production, rising salaries are not matched by rising educational quality, and rising commodity prices are not ameliorated by better infrastructure. High inflation will eat away at the ability of companies to sustain high margins, and markets usually demand a discount from high-inflation countries. Bottom line, one should not expect bad governance to lead to permanent positive payoffs.

Nevertheless, India has one considerable advantage from my point of view: its business model is based on bottom-up capitalism. Of course, anything is possible in the short run, but it seems inconceivable to me that state-directed investment policies could produce sustainable higher return on capital than those chosen by individual profit-maximizers.

In the final analysis, one needs to make the distinction not only between countries, but between companies and sectors based on their ability to produce and sustain high profitability rather than on simple metrics like GDP, which have very little to do with making money as investors.

In short, don't focus on growth. Focus on profitability. Obviously, as value investors, the single most important thing we look at is valuation – we are willing to pay a premium for profitability, but not to overpay for it.

Current positioning. At this point in time (January 2011), we are heavily underweight both India and China in our Emerging Markets Strategy, due primarily to high valuations in both countries relative to other emerging markets. In addition, in both countries, the central banks appear to be behind the curve and they will have to act strongly to bring inflation down, a task that is made much harder by the profligate monetary policies of the developed markets, particularly the U.S.