

# AGENDA – READING THE XI LEAVES

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- What's going on in China
- How it affects how we invest within China
- How you should think about your EM/China exposure
- Two self serving ways to think about this
  - Use managers that modulate their China exposure
  - Use EM x-China strategy along China and EM managers to control overall China exposure

How we manage EM x China and what does it look like

# AGENDA – READING THE XI LEAVES

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- What's going on in China

# UNDERSTANDING CHINA - THE BIG PICTURE

*The most important policy shift is based on the identification of principal contradiction*

## Evolution of China principal contradiction as identified by the

Period	Party	Principal contradiction	Direction
1948		Capitalism vs socialism	Socialized existing capitalism economy
1956		Economic and cultural growth cannot meet people's demand	Increasing productivity and focusing on economic growth
1958		Capitalism vs socialism	It is the only change made within short period and a top leadership struggle ensued. More ideology oriented and it eventually led to Cultural Revolution
1981*		The ever-growing material and cultural needs of the people vs backward social production	Aggregate economic growth is most important task
2017		Imbalanced and inadequate development vs the people's ever-growing need for a better life	Narrow income inequality, address demographic challenge and focus on areas of national/strategic importance

Source: CCPNews, GMO; Note: \*it was first mentioned by Deng Xiaoping in 1978 and formally acknowledged by the Party in 1981

# THE CHINESE DREAM: “NATIONAL REJUVENATION”

*To restore its rightful place as the richest and most powerful nation*



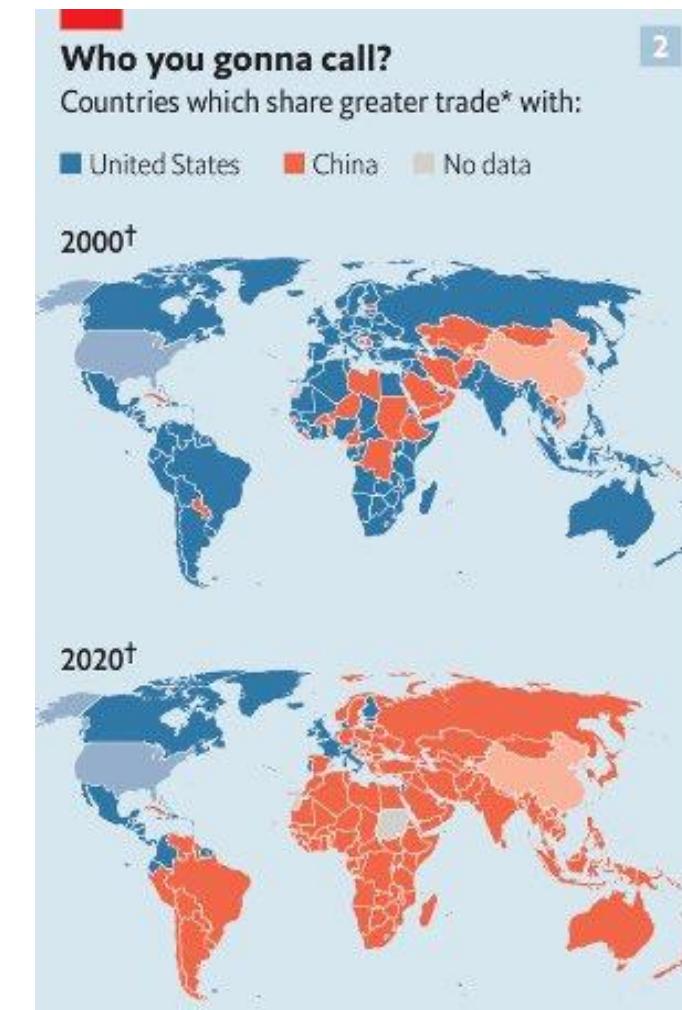
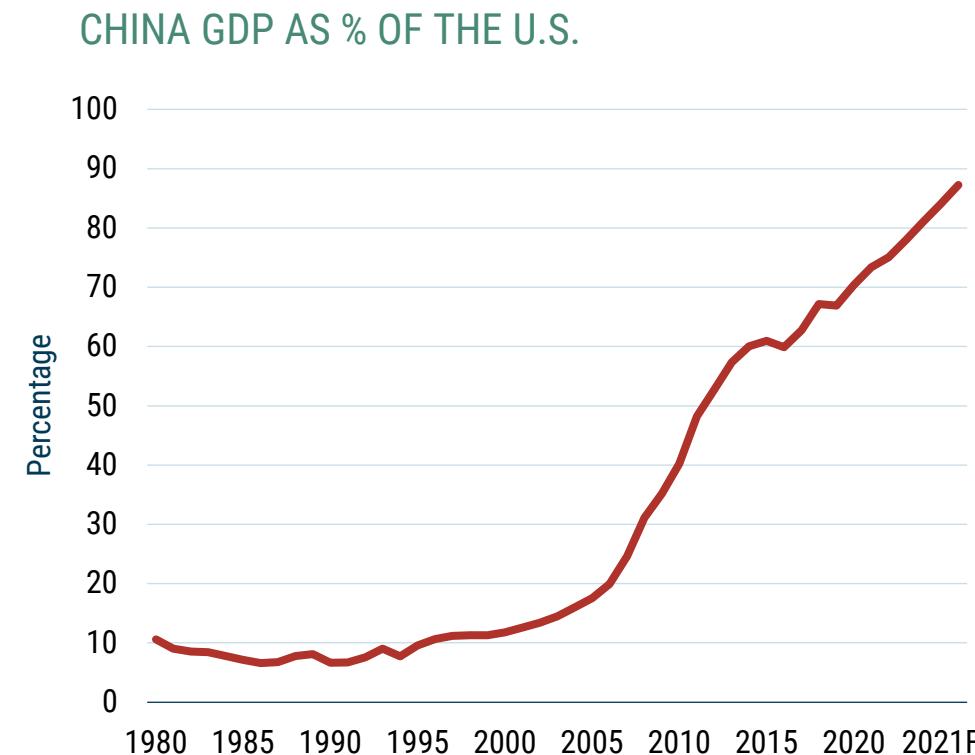
“China is a great nation...after the Opium War of 1840, however,...the country endured intense humiliation...national rejuvenation has been the greatest dream of the Chinese people and the Chinese nation.”

**– President Xi during 100<sup>th</sup> anniversary of CCP  
July 1, 2021**

Source: SCMP

# AND THAT DREAM IS NOW TANTALIZINGLY WITHIN REACH

*China's economic ascendance*



# BUT A POLICY SHIFT IS NEEDED TO MAKE FURTHER PROGRESS

*A principal contradiction, identified in 2017, must be resolved via targeted and deliberate policy*

Xinhua Insight: China embraces new "principal contradiction" when embarking on new journey

Source: Xinhua | 2017-10-24 09:45:14 | Editor: Yanai



"What we now face is the contradiction between unbalanced and inadequate development and the people's ever-growing needs for a better life...the evolution of the principal contradiction represents a historic shift that affects the whole landscape and that creates many new demands for the work of the Party and the country."

*– Xi Jinping  
October 18, 2017*

Source: Xinhua

# THREE STRATEGIC OBJECTIVES

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- 1) Reduce inequality: China's income inequality is among the highest in the world.
- 2) Address demographic timebomb: China's population is rapidly aging.
- 3) Prioritize industries of strategic importance: advance technology development to secure supply chain and achieve self sufficiency.

# THREE STRATEGIC OBJECTIVES

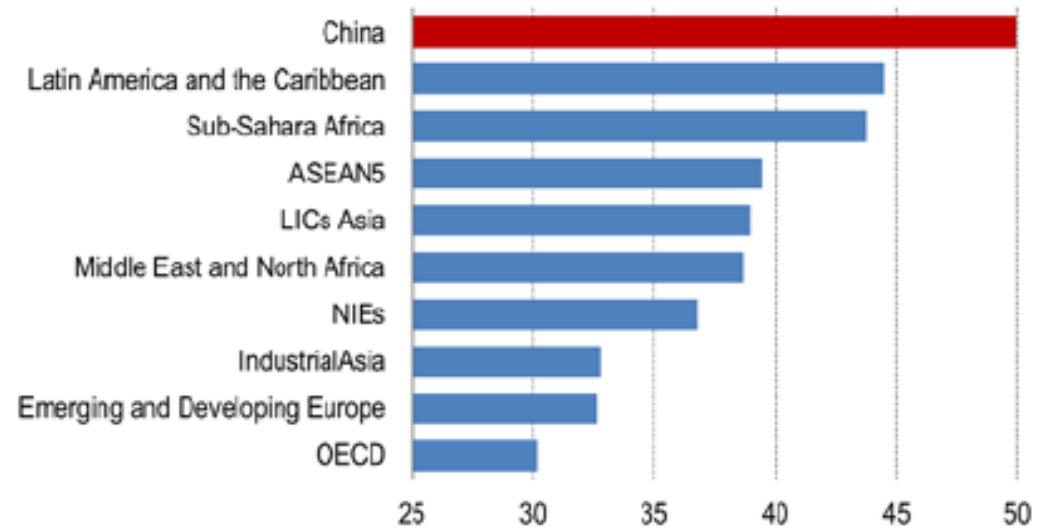
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- 1) Reduce inequality: China's income inequality is among the highest in the world.
  - Make housing affordable and reduce speculation in real estate – Evergrande
  - Narrow the education quality gap-private education companies-TAL, EDU
  - Take on billionaires - Alipay, Alibaba
  - More protection to employees-Meituan
  
- 2) Address demographic timebomb: China's population is rapidly aging.
  - Reduce the cost and stress of childrens education – Private education companies-TAL, EDU
  - Make housing affordable and reduce speculation in real estate – Evergrande
  - Reduce healthcare cost-Hengrui
  
- 1) Prioritize industries of strategic importance: advance technology development to secure supply chain and achieve self sufficiency.
  - Support Batteries-CATL, EV-BYD, NIO, Xpeng, Li Auto and other OEMs , semiconductor-SMIC, automation- Inovance
  - Reduce “useless' activities – gaming-Tencent, short video-Kuaishou

# REDUCE INCOME INEQUALITY/ IMPROVE QUALITY OF LIFE

## 1) Reduce income inequality: China's inequality is the highest in the world

**Figure 1: Regional Comparison of Income Inequality Levels**  
(Net Gini Index; in Gini points; year of 2015 (or latest available); average across the region)



Sources: SWIID Version 5.1; IMF, and IMF staff calculations.

Note: ASEAN = Association of Southeast Asian nations; LIC = low-income country; NIE = newly industrialized economy; OECD = Organization for Economic Cooperation and Development

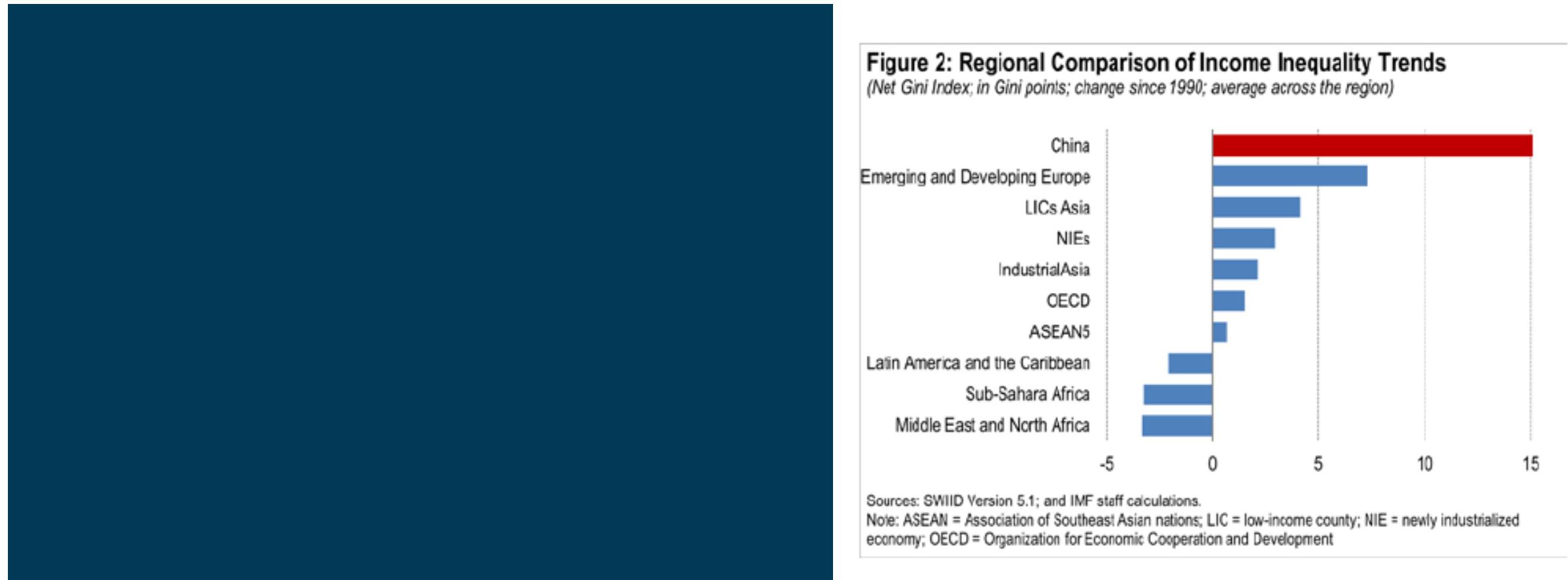


- Capital benefited disproportionately in the past and viewed as becoming too powerful to control.
- With a rising middle class, the demand for higher quality of growth, such as a cleaner environment, is also rising.

Source: IMF

# REDUCE INCOME INEQUALITY/ IMPROVE QUALITY OF LIFE

## 1) Reduce income inequality: And its got worse in the past 30 years



- Capital benefited disproportionately in the past and viewed as becoming too powerful to control.
- With a rising middle class, the demand for higher quality of growth, such as a cleaner environment, is also rising.

Source: IMF

# ADDRESSING THE DEMOGRAPHIC TIMEBOMB

## WHY DEMOGRAPHICS MATTER

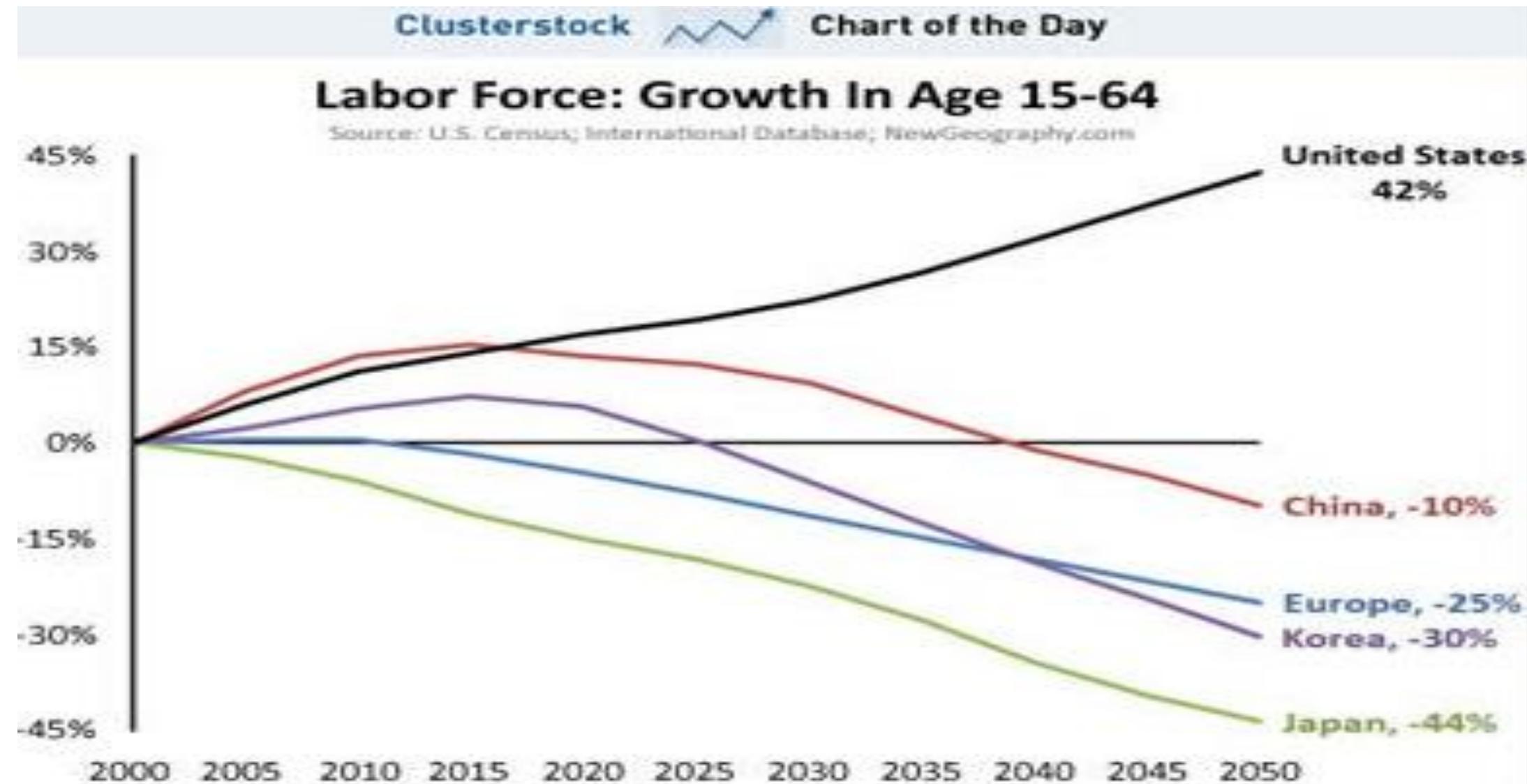
$$g_Y = g_A + \alpha_K g_K + \alpha_L g_L$$



Where:

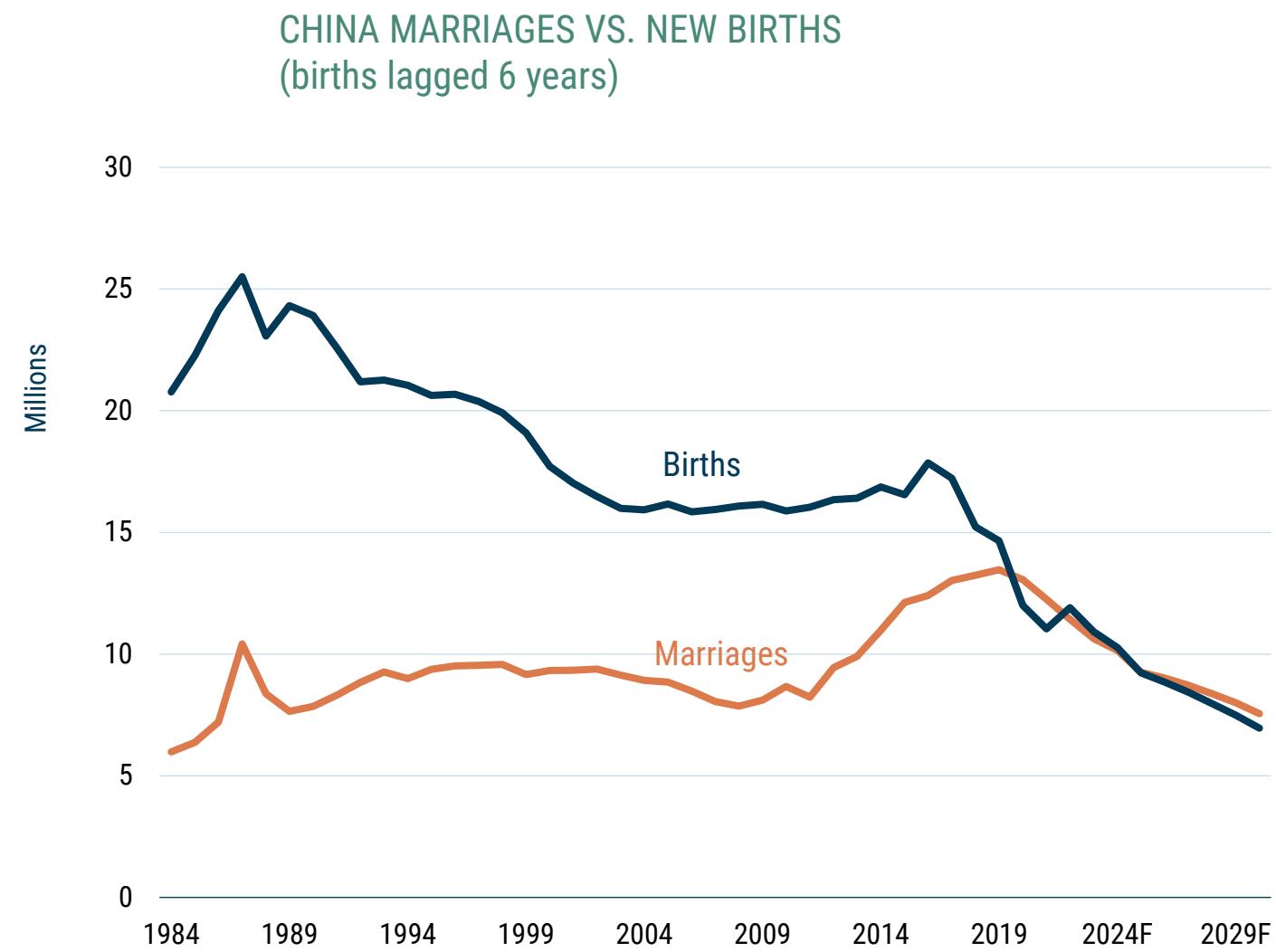
- $g_Y$  is GDP growth
- $g_A$  is TFP (Total Factor Productivity) growth
- $g_K$  is capital stock growth
- $g_L$  is labor force growth

# ADDRESSING THE DEMOGRAPHIC TIMEBOMB CHINA HAS A 2% ANNUAL GROWTH DRAG FROM A DECLINING WORKFORCE



# ADDRESSING THE DEMOGRAPHIC TIME BOMB

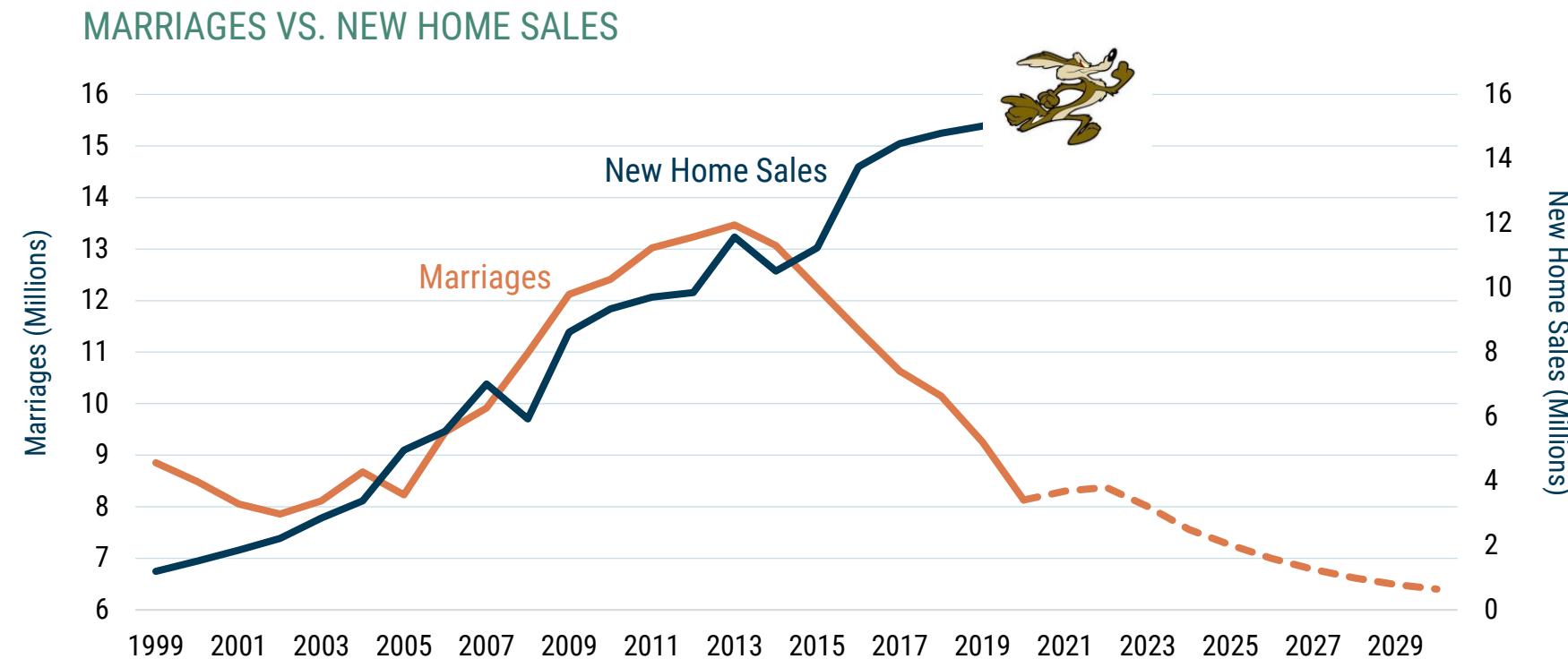
*And its about to get worse*



Source: Wind, Zeping Macro, GMO

# HOUSES ARE FOR LIVING IN, NOT FOR SPECULATION

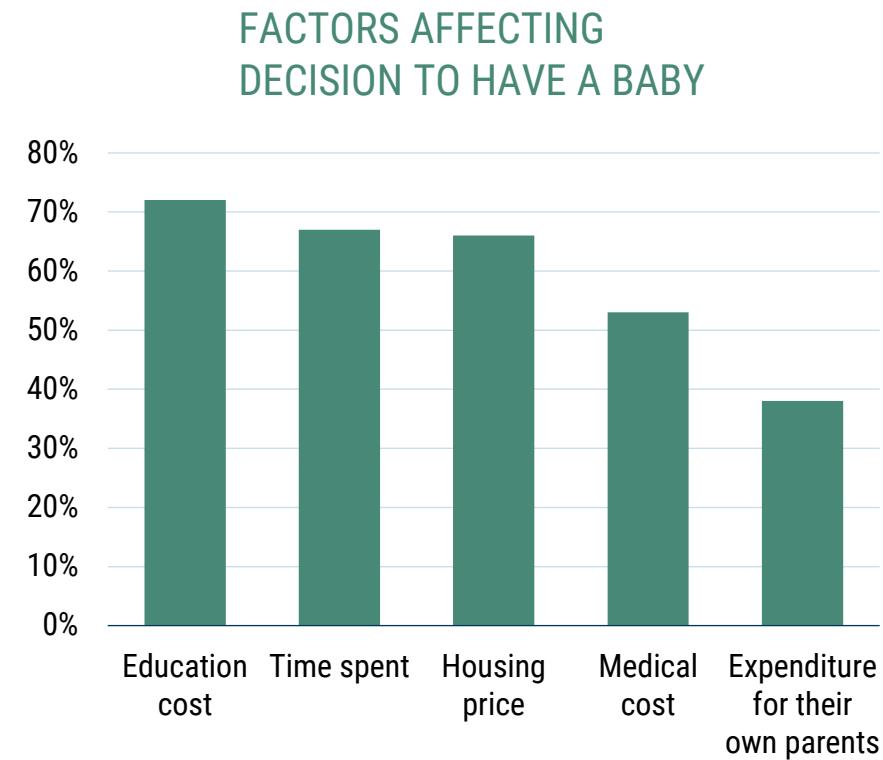
*A correction is long overdue*



Source: Wind, UN Population Division, GMO estimation

# ADDRESSING THE DEMOGRAPHIC TIME BOMB

*Why people are choosing to not have babies*



- In 2020, China new births dropped to 12m, or 47% of the peak in 1987.
- Based on our forecast, if the current trend continues, it will be 7m by 2030, 27% of 1987 and a further drop to 5m by 2040, 20% of 1987.
- Factors contributing to low birth rate should be addressed to mitigate decline in birth rates.

Source: Wind, Zeping Macro, GMO

# PRIORITIZE STRATEGIC INDUSTRIES

*Prioritize industries of strategic importance – advance technology development to secure supply chain and achieve self sufficiency*

The screenshot shows a news article from CNBC. At the top, there is a navigation bar with links to MARKETS, BUSINESS, INVESTING, TECH, POLITICS, CNBC TV, WATCHLIST, and PRO & TECH. The main headline reads: "From No. 1 to No. 6, Huawei smartphone shipments plunge 41% as U.S. sanctions bite". Below the headline, it says "PUBLISHED THU, JAN 28 2021 2:46 AM EST | UPDATED THU, JAN 28 2021 3:36 AM EST". There is a profile picture of Arjun Kharpal and a share button. A "KEY POINTS" section lists four bullet points about Huawei's decline. To the right, there is a "TRENDING NOW" sidebar with two items: "U.S.-China tensions official say in a 'tense'" and "Hong Kong index down 4% and education plunge".

**KEY POINTS**

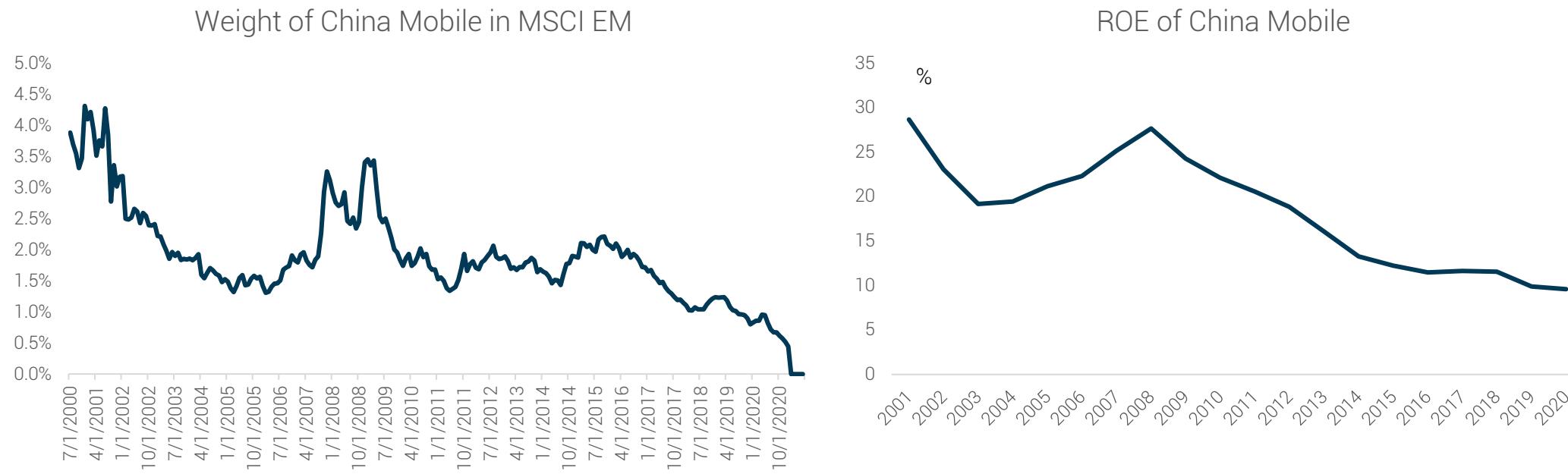
- Huawei shipped 33 million smartphones globally in the fourth quarter of 2020, a 41% year-on-year decline, making it the sixth-largest vendor in the world.
- The latest figures mark a sharp fall for Huawei versus the second quarter of 2020 when it was No. 1 in the world by shipments.
- U.S. sanctions have cut Huawei off from key software like Google Android and critical components like chips which have hurt its sales.
- Huawei's woes come as Apple shipped a record number of iPhones in the fourth quarter.

In this article: AAPL -0.96 (-0.85%)

Source: CNBC, WSJ

# THE PARTY GIVETH AND THE PARTY TAKETH AWAY – WILL CURRENT MARKET LEADERS SUFFER THE SAME FATE?

*Is Internet the new China Mobile?*

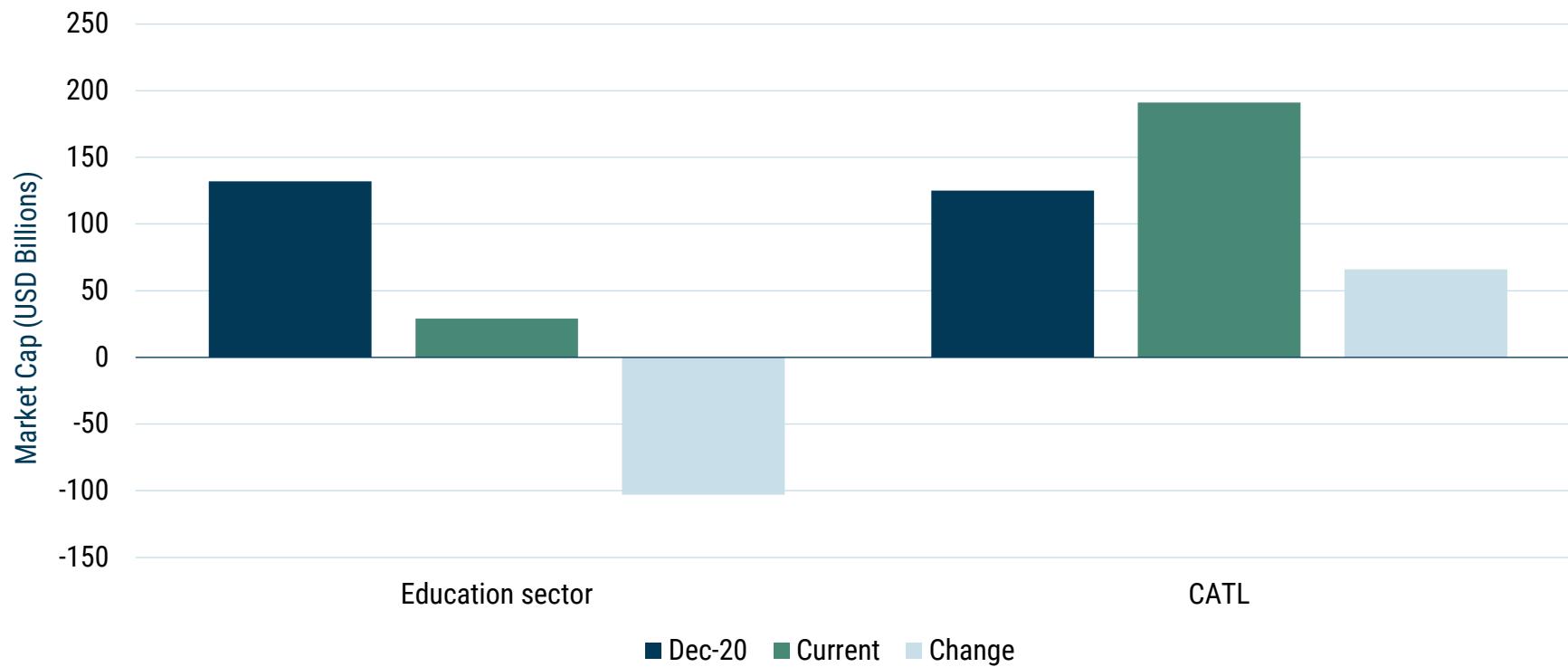


*"The focus is no longer the data but every user behind the data. Internet should back to "water-electricity-coal" (services provider). While still putting efficiency at top priority, it should balance fairness. Regulation is cooling down the disorder fever and make the infrastructure "on the cloud" materialized"*  
-Securities Journal commentary July 28, 2021

Source: Wind, Securities Journal

# REGULATION/STATE SUPPORT CREATES MASSIVE GAINS AND LOSSES

*Never forget my first rule of EM investing*



What could go wrong?

GMO



<https://www.project-syndicate.org/commentary/china-risky-business-crackdown-common-prosperity-campaign-by-raghuram-rajan-2021-09>

<https://www.project-syndicate.org/commentary/china-growth-prospects-clouded-by-redistribution-and-regulation-by-stephen-s-roach-2021-09>

<https://www.project-syndicate.org/commentary/china-evergrande-real-estate-economic-rebalancing-by-kenneth-rogoff-2021-09>



English ▾ 3

## Connecting the Dots in China

Sep 27, 2021 | STEPHEN S. ROACH

The new dual thrust of Chinese policy – redistribution plus re-regulation – will subdue the entrepreneurial activity that has been so important in powering China's dynamic private sector. Without animal spirits, the case for indigenous innovation is in tatters.

### FEATURED

1

Goodbye to the German Status Quo

Sep 27, 2021 | MELVYN B. KRAUSS



## China's Risky Business Crackdown

Sep 29, 2021 | RAGHURAM G. RAJAN

Like the earlier campaign against corruption, Chinese President Xi Jinping's effort to control China's private sector is agreeable in its stated intentions, but questionable in its implementation. Quite possibly, the campaign for "common prosperity" will undermine the economic sectors that China needs to reorient its growth model.

### FEATURED

1

Goodbye to the German Status Quo

Sep 27, 2021 | MELVYN B. KRAUSS



## China's Housing Conundrum

Sep 29, 2021 | KENNETH ROGOFF

The Chinese government may yet succeed in insulating the broader market from the financial crisis at real estate giant Evergrande. But the larger challenge is to rebalance an economy that has depended for far too long on the bloated housing market for jobs and growth.

### FEATURED

1

Goodbye to the German Status Quo

Sep 27, 2021 | MELVYN B. KRAUSS

# AGENDA – READING THE XI LEAVES

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- How it affects how we invest within China

# FRAMEWORK TO IDENTIFY STRATEGIC HEADWINDS / TAILWINDS

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## The Chinese Dream

- Promote technological advancement/secure supply chain
- Narrow income inequality
- Ease household burdens/improve demographics

## Social Impact

- Environmentally friendly
- Enable fair competition and fair compensation
- Do not create anxiety
- Do not waste time

## Security

- Strengthen national security
- Improve data security

## State Control

- Government influence (ownership or control)
- Attitude towards government

## Excessive Wealth

- Number of billionaires

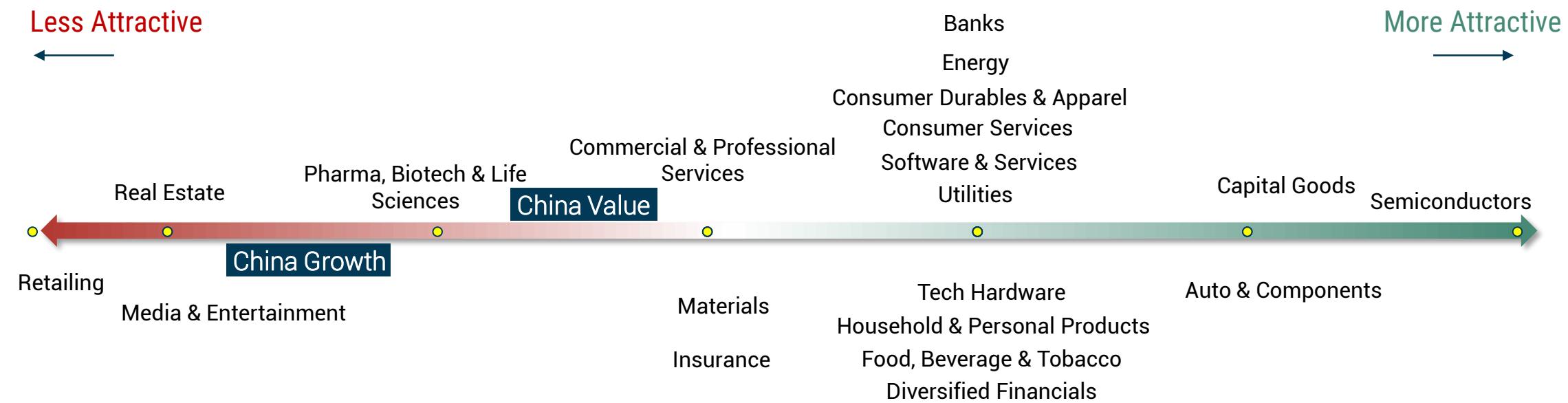
Source: GMO

# APPLYING THE FRAMEWORK TO SELECT INDUSTRIES

*A work in progress*

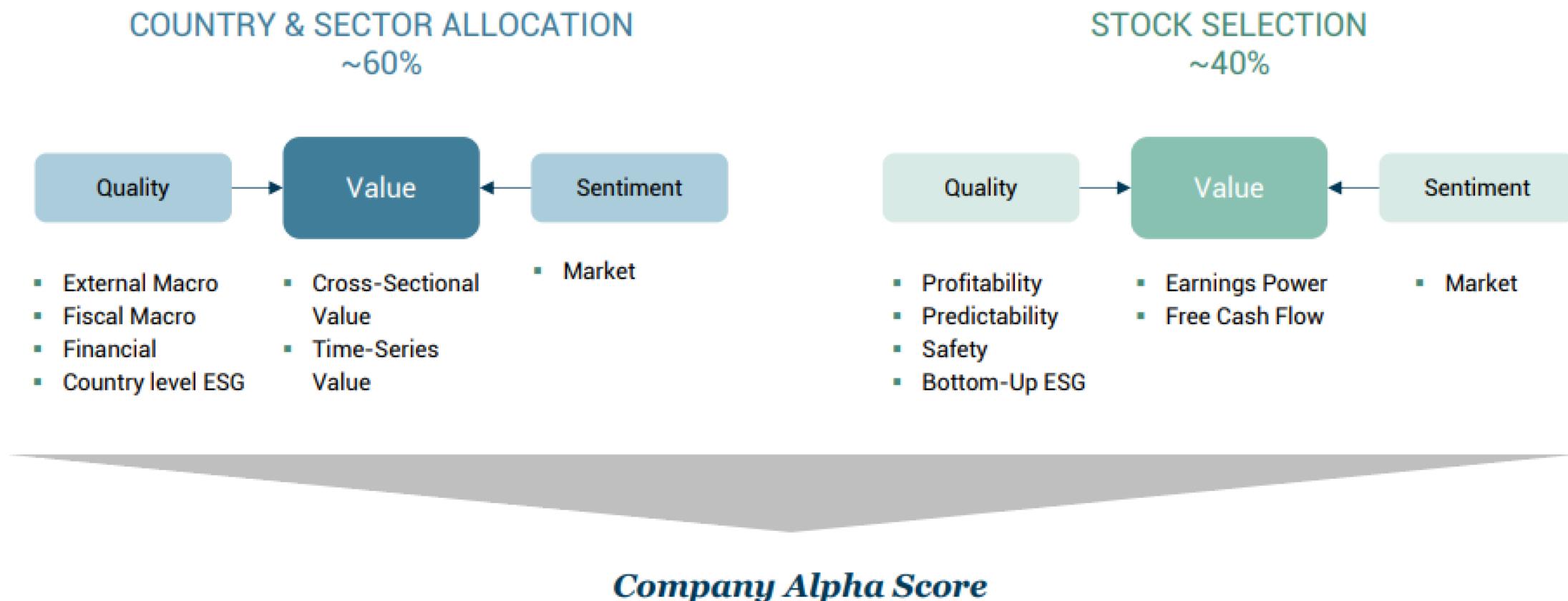
Sector	The Chinese Dream	Social Impact	Security	State Control	Excessive Wealth Created	Total
Auto (EV)	1	1	-1			1
Capital goods	1					1
Chinese top brand apparel		1				1
Diversified Financials	1		-1			0
E-commerce		-1	-1	-1	-1	-4
Energy		-1		1		0
Food delivery		-1	-1	-1	-1	-4
Gaming	-1	-1	-1		-1	-4
Healthcare	-1				-1	-2
Home appliance and electronics	1				-1	0
Insurance			-1			-1
Liquor		-1		1		0
Materials		-1				-1
Real estate	-1	-1			-1	-3
SOE Banks			-1	1		0
Solar	1	1				2
Technology and hardware	1					1

# GROWTH SECTORS MORE AT RISK THAN VALUE SECTORS



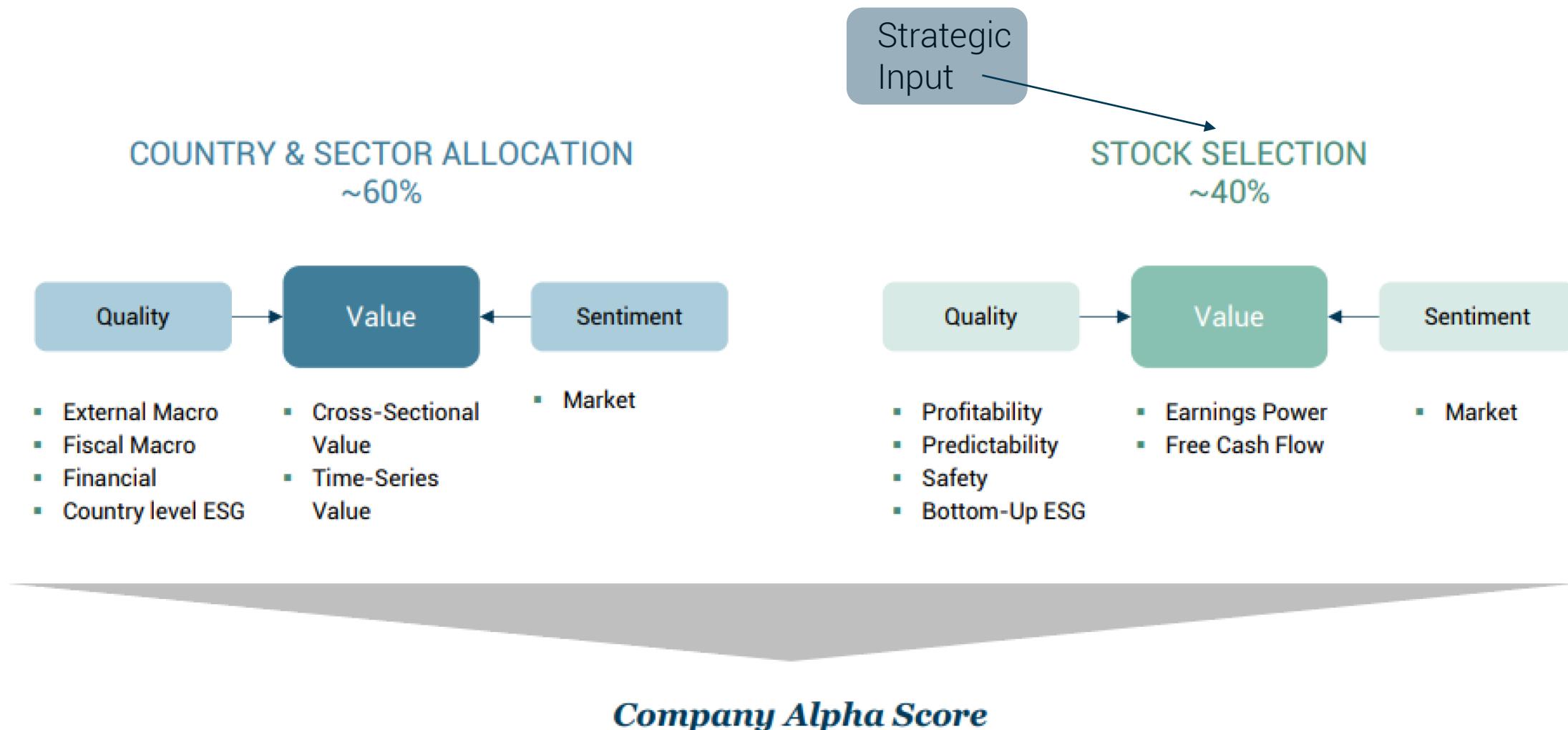
# QUANTITATIVE ALPHA MODELS

*Combine robust country, sector, and stock valuation models*



# QUANTITATIVE ALPHA MODELS

*Combine robust country, sector, and stock valuation models*



Example of how stock score has changed  
Alibaba

Before:

$$\begin{array}{r} \text{Quality} + \\ 0.3 \end{array} \quad \begin{array}{r} \text{Value} + \\ 0.1 \end{array} \quad \begin{array}{r} \text{Sentiment} = \\ -1.4 \end{array} \quad \begin{array}{r} \text{Overall Score} \\ 0.1 \end{array}$$

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After:

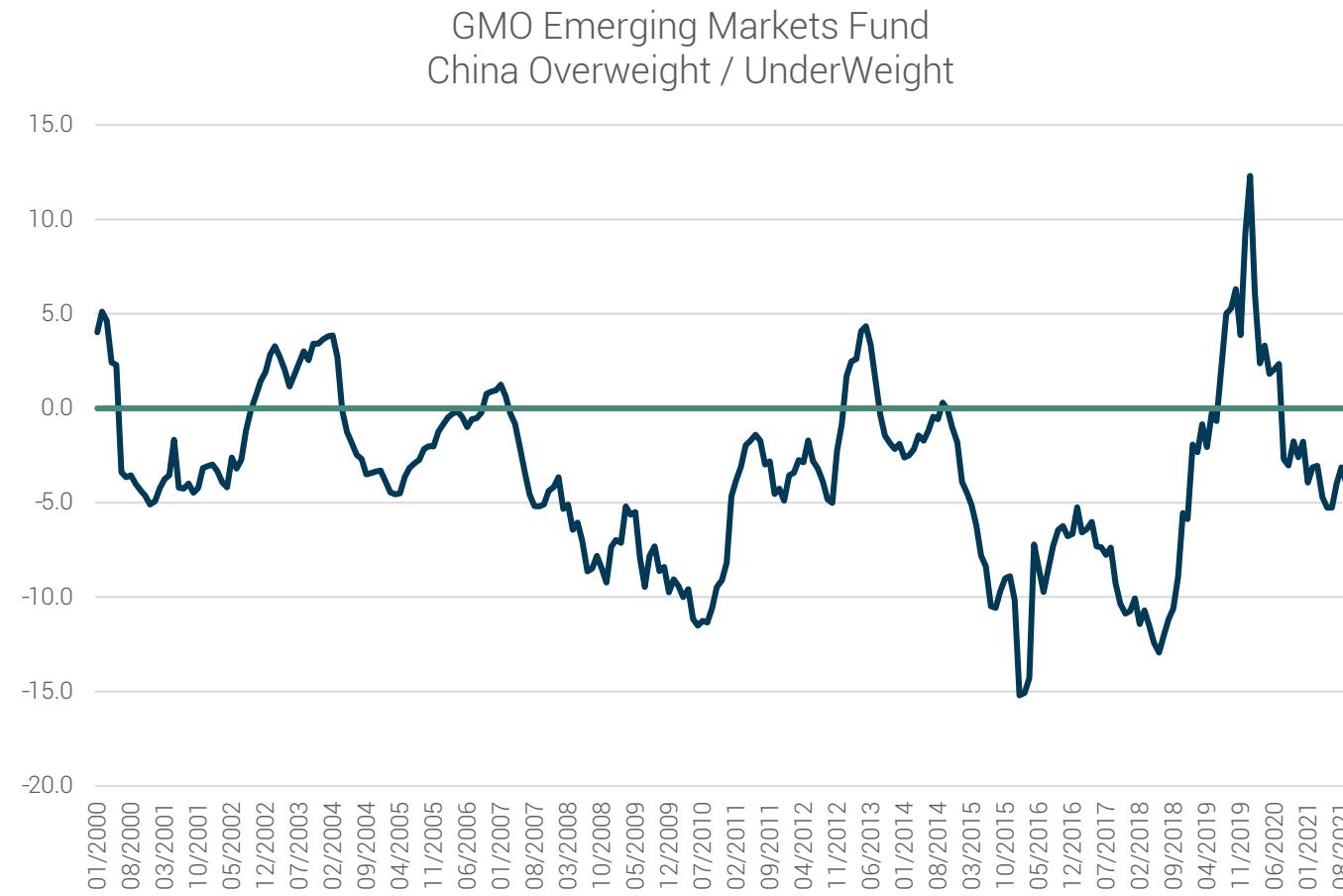
$$\begin{array}{r} \text{Quality} + \\ 0.3 \end{array} \quad \begin{array}{r} \text{Value} + \\ 0.1 \end{array} \quad \begin{array}{r} \text{Sentiment} + \\ -1.4 \end{array} \quad \begin{array}{r} \text{Strategic} = \\ -4.0 \end{array} \quad \begin{array}{r} \text{Overall Score} \\ -0.3 \end{array}$$

# AGENDA – READING THE XI LEAVES

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- How you should think about your EM/China exposure
  - Use managers that modulate their China exposure
  - Use EM x-China strategy along China and EM managers to control overall China exposure

# HOW TO THINK ABOUT CHINA EXPOSURE



# HOW TO THINK ABOUT CHINA EXPOSURE

*The Case for EM x-China*

China	Broad EM	Broad EM x-China	Total EM	China %
5%	5%		10%	7.00%
5%		5%	10%	5.00%

# EMERGING MARKETS EX-CHINA STRATEGY

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# GMO EM EX-CHINA STRATEGY

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- Exactly same process as GMO Emerging Markets Strategy (EMF) but with China removed from benchmark and eligible universe
- What are the implications and what does one give up?

## EM EX-CHINA STRATEGY

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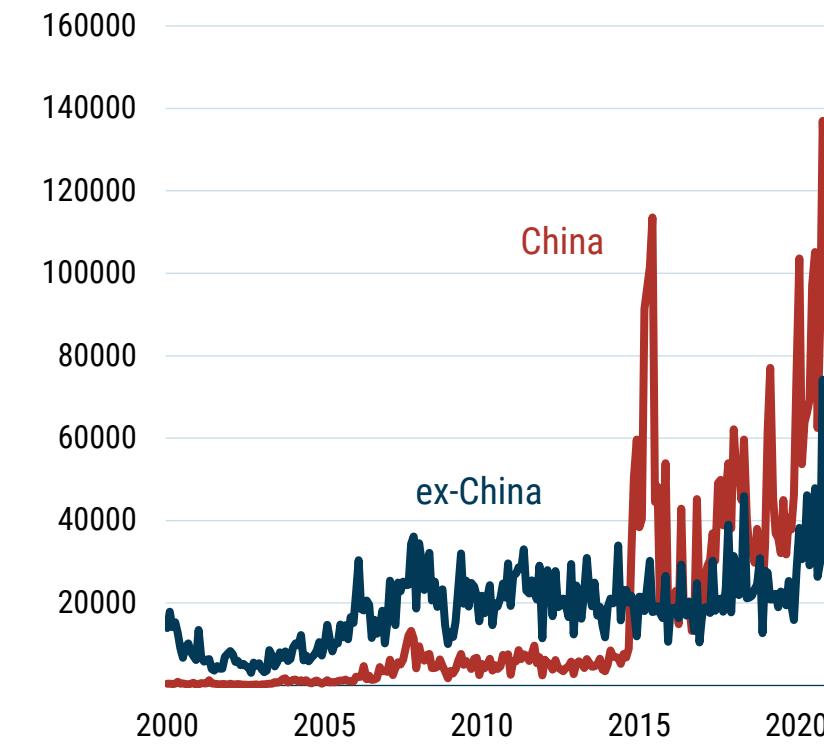
- Removal of China results in loss of ~40% of stock opportunity set
- Our emphasis on top-down significantly mitigates this loss
  - ex-China takes away ~40% of companies but just 1 country
- Country active bets are very similar in ex-China strategy
- Key portfolio characteristics (Value and Quality superiority) are very similar in ex-China strategy

# CHINA VS. EX-CHINA METRICS

NUMBER OF SECURITIES



VOLUME (USD MILLIONS)



As of 8/31/21

# EMERGING MARKETS EQUITY

## *Core beliefs and competitive advantages*



### **Emphasis on top-down**

Getting the big picture right is the most important thing. We identify and overweight the most attractive countries and sectors.



### **Quantitative and Fundamental**

We use a combination of quantitative and fundamental insights to add value.



### **Value wins**

We believe value wins over the long run. The more inefficient the asset class, the better it does.

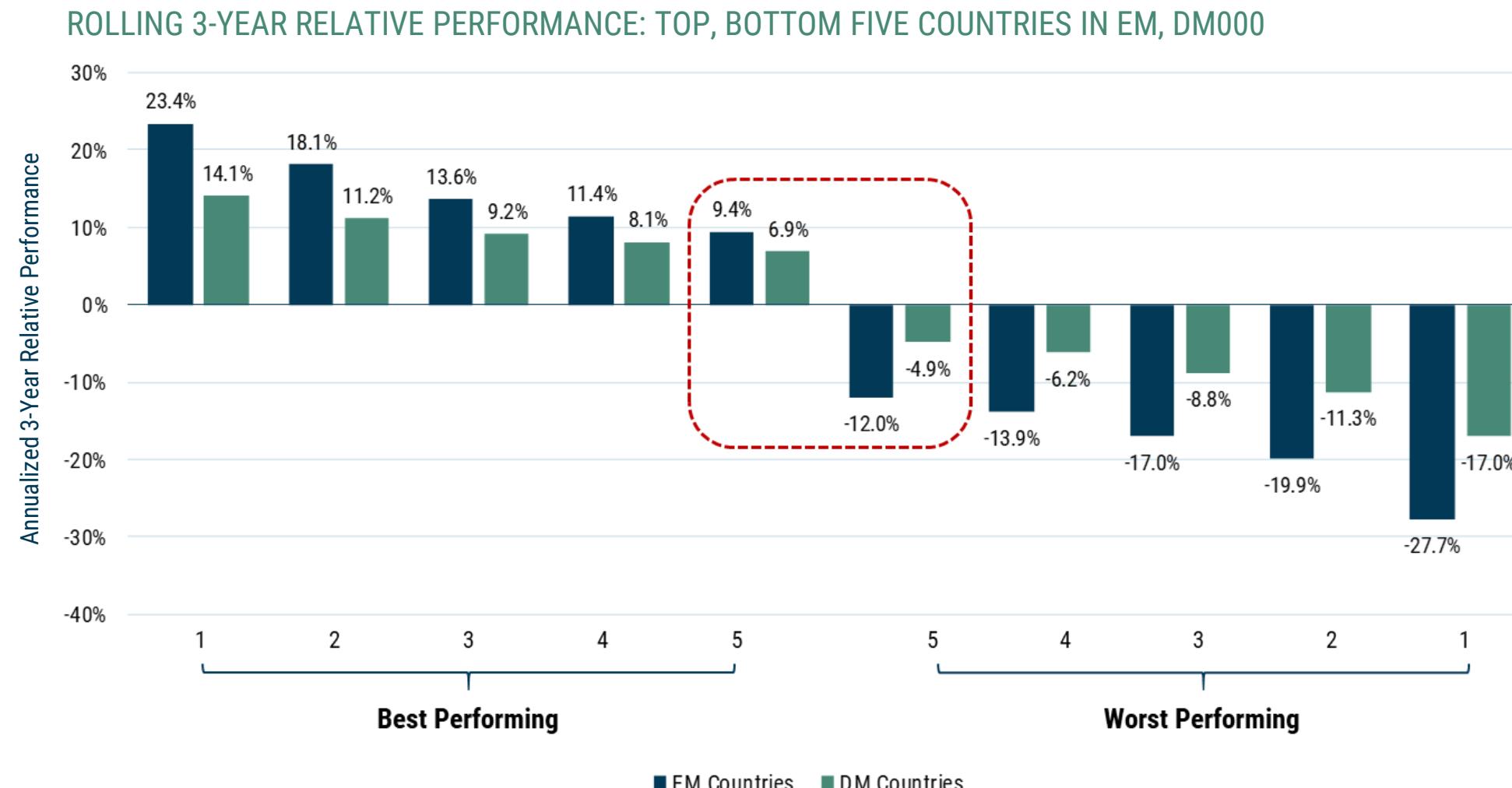


### **Disciplined approach**

Our approach is a consistent, thorough, and adaptable way of capturing these insights, while avoiding the pitfalls caused by emotion.

# THE TOP-DOWN OPPORTUNITY IS SIZABLE

*Picking the right countries is important – much more so in EM than in DM*

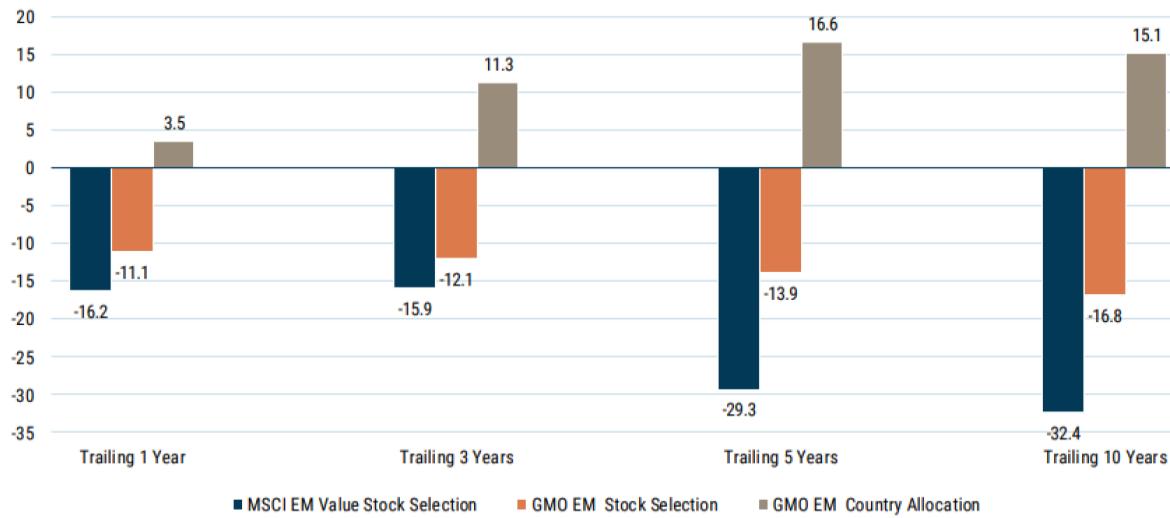


1/31/00 - 12/31/20 | Source: MSCI, S&P, GMO

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# TOP DOWN MATTERS – AND WE'RE GOOD AT IT

## CUMULATIVE PERFORMANCE ATTRIBUTION VS. MSCI EMERGING MARKETS INDEX



As of 9/30/20 | Source: MSCI, GMO

Performance data quoted represents past performance and is not predictive of future performance. Gross returns are presented gross of management fees and any incentive fees if applicable. Gross returns include transaction costs, commissions, withholding taxes on foreign income and capital gains and include the reinvestment of dividends and other income, as applicable. If management fees were deducted performance would be lower. A Global Investment Performance Standards (GIPS®) compliant presentation is available by clicking the GIPS® Compliant Presentation link on GMO's website. GIPS® is a registered trademark owned by CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. The above information is based on a representative account in the Strategy selected because it has the fewest restrictions and best represents the implementation of the Strategy. MSCI data may not be reproduced or used for any other purpose. MSCI provides no warranties, has not prepared or approved this report, and has no liability hereunder.

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GMO | 25

As of 6/30/21 | Source: GICS Sector Report

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# EMERGING MARKETS EX-CHINA: PORTFOLIO CHARACTERISTICS ARE VERY SIMILAR

	<b>GMO Emerging Markets (Simulated)</b>	<b>MSCI Emerging Markets Index</b>	<b>GMO Emerging Markets ex-China (Simulated)</b>
Price/Earnings	10.2 x	19.7 x	12.2 x
Price/Book	1.2 x	2.1 x	1.5 x
Dividend Yield	4.4 %	1.9 %	4.4 %
Return on Equity	13.6 %	11.3 %	13.8 %

As of 6/30/21 | Source: GICS Sector Report

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# EMERGING MARKETS EX-CHINA: PORTFOLIO CHARACTERISTICS ARE SIMILAR

## SECTOR POSITIONING (%)

	<i>GMO Emerging Markets ex-China (Simulated)</i>	<i>GMO Emerging Markets (Simulated)</i>	<i>MSCI Emerging Markets Index</i>
Materials	16%	14%	8%
Consumer Staples	8%	5%	6%
Utilities	3%	2%	2%
Real Estate	2%	4%	2%
Industrials	6%	3%	5%
Communication Services	7%	8%	11%
Energy	7%	7%	5%
Health Care	2%	1%	5%
Information Technology	27%	25%	20%
Financials	18%	23%	18%
Consumer Discretionary	5%	8%	18%

As of 6/30/21 | Source: GICS Sector Report

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# EMERGING MARKETS EX-CHINA: PORTFOLIO CHARACTERISTICS ARE VERY SIMILAR

## COUNTRY POSITIONING (%)

	<b>GMO Emerging Markets ex-China (Simulated)</b>	<b>MSCI Emerging Markets ex-China Index</b>	<b>Difference</b>
Russia	18%	5%	13%
Taiwan	30%	22%	7%
Mexico	8%	3%	6%
Turkey	6%	0%	5%
Peru	3%	0%	2%
South Africa	3%	6%	-3%
Saudi Arabia	2%	5%	-3%
Brazil	3%	8%	-6%
Korea	13%	21%	-8%
India	0%	16%	-16%

	<b>GMO Emerging Markets (Simulated)</b>	<b>MSCI Emerging Markets Index</b>	<b>Difference</b>
	18%	3%	15%
	25%	14%	11%
	5%	2%	3%
	2%	0%	2%
	1%	0%	1%
	1%	4%	-2%
	0%	3%	-3%
	0%	5%	-5%
	6%	13%	-7%
	0%	10%	-10%

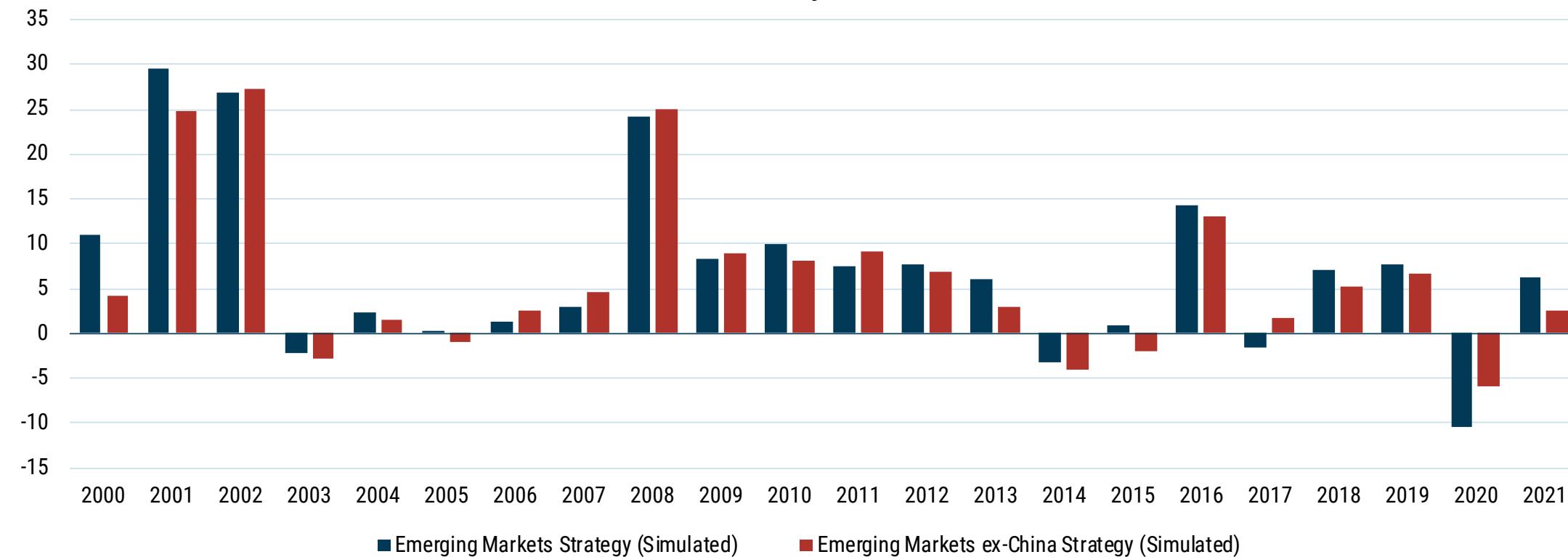
As of 6/30/21 | Source: MSCI, GMO

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# EMERGING MARKETS EX-CHINA: ABILITY TO DELIVER ALPHA REMAINS CONSISTENT

ALPHA YEAR-BY-YEAR



BINU – redo this chart as a  
xy scatter chart

As of 6/30/21 | Inception date: 12/31/93

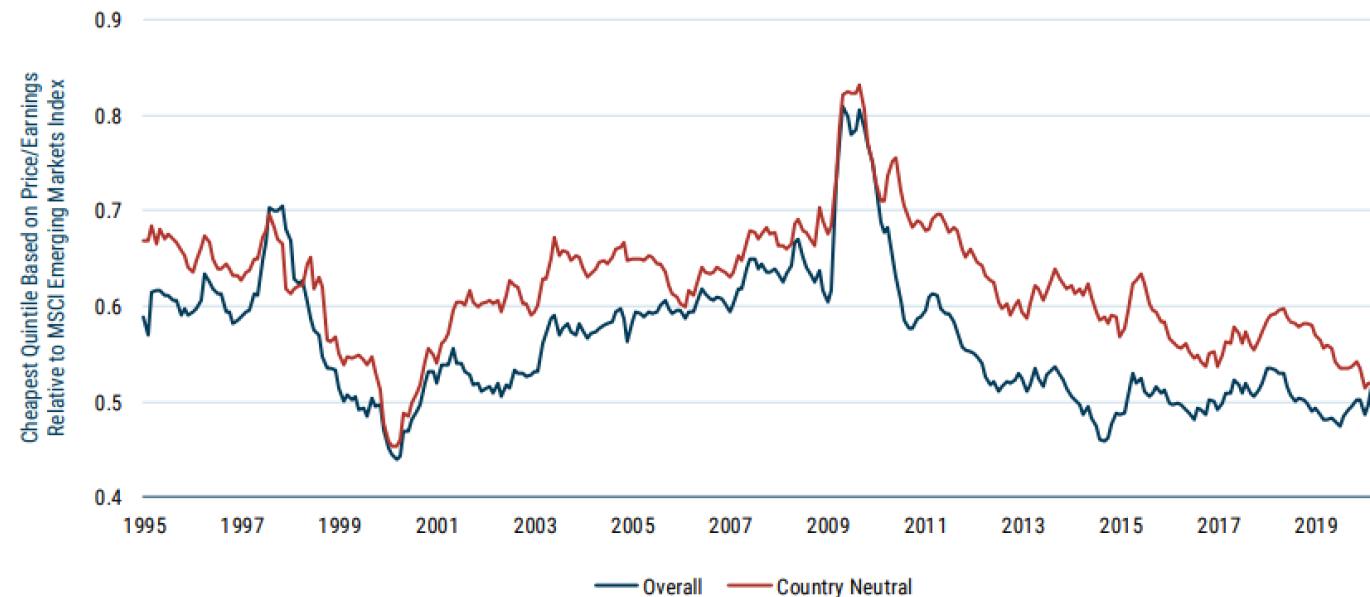
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Past performance, whether actual or simulated, is no guarantee of future results. Please see important information at the end of this presentation for additional disclosures.

# EMERGING MARKETS EX-CHINA: THE KICKER – VALUE IN EM IS EXTRAORDINARILY POISED FOR A MASSIVE REBOUND

## VALUE WITHIN EMERGING MARKETS WELL POSITIONED RELATIVE TO HISTORY

*Price/Earnings ratio*



As of 6/30/21 | Inception date: 12/31/93

**Performance data quoted represents past performance and is not predictive of future performance.** Returns are presented gross of management fees, net of transaction costs, and include the reinvestment of dividends and other income. If management fees were deducted performance would be lower. For example, if the strategy were to achieve a 10% annual rate of return each year for ten years and an annual advisory fee of 0.75% were charged during that period, the resulting average annual net return (after the deduction of management fees) would be 9.25%.

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