STONEHORN GLOBAL PARTNERS

The world is changing, so why isn't your portfolio changing with it?

China is living the American Dream

MAY 2020

The American dream is alive and well in China, which is succeeding where the United States is failing.

By Sam Lecornu, co-founder and CEO

It would be easy to crow. Since the lows of March 23rd, core Stonehorn portfolio holdings including Alibaba, BYD, Tencent and Kakao have risen 14%, 31%, 24% and 61% respectively.

This was not in the plan. We owned these stocks before the pandemic took hold but in many cases seized the opportunity to top up our allocations at attractive prices.

The strength of the rebound in tech stocks is eye-catching nonetheless. The share price rebounds of Apple, Facebook and Google have been similarly impressive, suggesting a tech-based parallel between the US and China. In the short term at least, there's probably some truth to that. Over the long term it couldn't be more different.

Whilst companies like Apple and Facebook are the contemporary tech equivalents of consumer-based stocks like Kraft, Ford and Kodak, the great, consumer-driven societies that delivered wealth to the west in the post-war period are declining.

According to a 2019 OECD report, the middle class in richer countries has shrunk from 64% of the population in the mid-1980s to 60% now. In the US in 1971, the middle class accounted for 61% of the population but now registers at just over 50%.

Whilst the top 1% have taken the lion's share of economic growth over the past few decades, those in the middle have leveraged up to maintain the quality of their lives, preoccupied by fears of slipping down the ladder.

From above and below, the US middle class in particular is being squeezed and social mobility is declining. As the OECD writes, "The middle class used to be an aspiration. For many generations it meant the assurance of living in a comfortable house and affording a rewarding lifestyle. However, there are now signs that this bedrock of our

About Stonehorn Global Partners

We believe that an alignment of interest with our clients is what builds sustainable partnerships.

- Stonehorn's founding members have partnered together in Asia for over 12 years.
- Strong track record investing in Asian equities.
- Extensive network and relationships with Asian companies, government bodies and industry contacts.
- A high conviction, long-only portfolio of Asian stocks, actively managed, unconstrained and benchmark unaware.

democracies and economic growth is not as stable as in the past."

After increasing steadily for centuries, life expectancy in the US is now flatlining, the cost of healthcare and education is rising and the prospect of owning one's own home is increasingly out of reach. As with the global financial crisis, the pandemic is only likely to heighten these disparities, sowing further political discord. For a growing number of people the American dream remains just that.

"In 2019, China's universities produced 8.34 million students compared to 3.9 million in the United States."

This may not be an impediment to stocks like Apple, which targets a high socio-economic demographic. But middle class decline is affecting plenty of US businesses, from JC Penny to Victoria's Secret.

Successful US companies target either the cost-conscious consumer in the manner of Costco and McDonald's or those sitting at the top of the wealth ladder, where brand and image count more than price. No one wants to be stuck in the middle.

This is hurting consumption. A 2016 IMF working paper estimates that between 1998 and 2013, the U.S. economy "lost the equivalent of more than one year of consumption due to increased polarization." That trend is likely to have increased in the last few years.

The contrast with China could not be more stark. According to the Center for Strategic and International Studies, in 2002 just 4% of China's population was considered middle class (expressed as USD$10-$50 per day spending power, in purchasing parity terms). By 2012 that figure had increased to 31%.

China's growing middle class is an expression of long term government policy to enhance the country's economic standing and the lives of people within it. More recently, that has led to a focus on consumption rather than investment - unachievable without putting more money in ordinary people's pockets.

There are other factors at play. In 1980, less than a fifth of China's population lived in urban areas. By 2017, that figure had increased to 31%. This percentage will inevitably rise in the decades to come. There are 560m people still living in rural China.

Average incomes are rising as a result. Residents of large urban conurbations like Beijing and Shanghai enjoy per capita disposable incomes of around USD$10,000 and USD$25,000 a year, respectively. A McKinsey study estimates that 76% of China's urban population will be considered middle income by 2022 (defined as annual household earnings of USD$9,000 - USD$34,000).

These figures are well known and understood. What is less familiar to western investors are the consequences.

Largest retail market in the world

According to Emarketer, China is now the largest retail market in the world. In 2019, over 21 million passenger vehicles were sold in China compared to 4.7 million in the United States. In the same year, China's universities produced 8.34 million students compared to 3.9 million in the US.

Educational attainment in metropolitan areas is improving with Chinese students in Beijing and Shanghai performing near the top of global rankings in maths and science. In 2018, China had more startups worth in excess of USD$1 billion than the United States, where company formation per capita is falling.

The compact China's political elite has struck with its vast population is explicit and enduring; grant us centralised control and we will deliver to you an improved standard of living, more economic freedom and a flourishing middle class. Political freedom has been traded for economic liberty and progress.

The dying American dream

In the United States, political freedom remains admirably strong but economically America is beginning to fail where China is succeeding.

The average American now faces a declining standard of living, lower social mobility and more expensive education and healthcare. The American dream, at least in a materialist sense, is now more achievable in China than it is in the United States.

Now, ask yourself this: where would you rather invest? Our team has been living and investing in Asia for 12 years. With every trip to China, we see the country's impressive growth and the effects government policy is having on the lives of its people.

There are risks of course. China *is* different, although the country's leadership, committed to state-based capitalism, actively promotes and protects the interests of companies it considers economically critical, making many of our Chinese investments safer than their western counterparts.

But even if one accepts a higher degree of risk, that is more than offset by the price. You can buy Amazon right now on a price-to-earnings ratio of 62; Alibaba, a company we believe has even better growth prospects, is available at half that. The same goes for Google versus Baidu.

A deep understanding of the economic forces at play in China helped John Lam, Duke Lo and myself turn an initial small investment in our previous Asian fund, into USD$4.5bn with USD$1.0bn of realised gains in under a decade. We plan to do the same returns for our clients at Stonehorn. Since launching our new fund last year we believe we are on track.

If investors want to benefit from rising incomes, a burgeoning middle class and compelling valuations, the conclusion in my view is undeniable. China needs more attention than you're probably giving it.

> "China offers the kind of opportunities once apparent in a post-war US."

I want to be clear about this; this is not an argument to sell your US or European exposures in favour of Asia generally or China in particular. That would be foolish. What makes more sense at a time when most investors are underweight China is to consider a portfolio weighting commensurate with the country's economic power and opportunity.

For those interested in long-term wealth creation backed by undeniably favourable tailwinds, China offers the kind of opportunities that were once apparent in a post-war United States, at more attractive prices.

Having been fully invested in the region for over 12 years, we're familiar with the environment and are comfortable with the risks. We also understand why others are less comfortable. But the case for dipping your toe in the water is compelling.

The world is changing. Shouldn't your portfolio be changing with it?

About the Investment Team

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20 years industry and funds management experience

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Stonehorn Global Partners (Stonehorn) is majority owned by its staff who believes that an alignment of interest with their clients is what builds sustainable partnerships.

Stonehorn's founding members have partnered together in Asia for over 12 years and have a long and strong record investing in Asian equities. Since then they have built an extensive network of relationships with Asian companies, government bodies and industry contacts.

This level of access together with their experience allows them to select investments carefully by cross-checking investment assumptions with management discussions, financial analysis and industry checks.

Stonehorn conducts research via a deep dive bottom up approach focusing on Environmental, Social and Governance (ESG) factors. Stonehorn's proprietary due diligence and research methods are based on a seamless collaboration with each member correctly trusting each other.

For more information visit: www.stonehornpartners.com

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