

SECTION III. THE STRATEGIES

Armed with the information contained in the first two sections of this book, you are now ready to review various investment strategies for profiting from China's growth. We start this section with a chapter appropriately titled The Preparation. Here, we guide you through the very necessary process of knowing how to evaluate your capacity for risk and how to allocate your assets. The following three chapters then described markedly different approaches for investing in China: a diversified approach utilizing investment funds dedicated to China companies; a lower risk approach through buying funds and other instruments that are organized outside of China but that profit indirectly from China's growth; and a very risky but potentially lucrative approach utilizing the purchase of individual Chinese stocks. In the last chapter, we present our recommendations for a mixed strategy that provides the best balance of potential reward and risk for investors.

PT;11/02/06;5055

BGM 11/10/06

PT;11/20/06;4566

BGM; 11/30/06; 4526

BGM; 1/12/07; 4455

PT;1/16/07

BGM;1/22/07

PT;1/28/07

BGM;1/30/07;4884

BGM;2/15/07;4884

CHAPTER 8

THE PREPARATION

To be prepared is half the victory.

--Miguel De Cervantes

Before undertaking any investment, investors need to understand something about what they are buying and how that investment fits in with their risk level and the allocation of their wealth. In the case of investing in China, a country that has undergone a remarkable and yet unique transformation over the past three decades, such understanding is crucial. That's what this chapter is all about.

China: What You Are Buying

There is no historical precedent for the enormous economic success story that has been played out in China since the economic reforms instituted by Deng Xiaoping. Now

well into its third decade, China's real growth rate has been a relatively steady 9 to 10 percent per year and was proceeding beyond that rate as this book went to press. Undoubtedly, the growth rate will slow in the future – but we believe that China will continue to experience exceptional growth for the coming decades and at rates well above those of any other large country in the world. We believe that every investment portfolio should have some exposure to the growth of China.

Similarly, there is no historical precedent for the kind of stock market that has evolved in China. As described in Chapter 4, it is one still dominated by state-owned enterprises (SOEs) and open to private firms started by entrepreneurs. Within the investment community, there is a great debate as to which kind of enterprise one should invest in: the SOE or the private firm. Those who favor SOEs point out that with the government in control, the companies will never fail.

Those who are wary of SOEs point to China Petroleum and Chemical Corporation. A petrochemical refining and production company, this SOE ranks among China's most profitable companies and has both a low P/E and PEG ratio. So what's the catch? To begin, even trying to define this company is difficult. It was established as a joint stock limited company in 2000 under Company Law of the People's Republic of China with Sinopec Group Company as the sole shareholder. Thus, the company is often known as Sinopec; its ticker symbol on the New York Stock Exchange is SNP. The company is an SOE because the government holds 70 percent of Sinopec's shares. There are more than 80 subsidiaries associated with the company; some of these, such as Shanghai Petrochemical Co. Ltd. (SHI), also trade on the New York Stock Exchange.

The Chinese government has a very heavy hand in Sinopec's operations. While the government allows crude oil prices to move in line with international markets, it controls refined oil products. In times of high and rising crude oil prices, the government keeps refined oil prices artificially low in keeping with its goal of creating a harmonious society and avoiding civil unrest. In the late 2004-late 2006 period, for example, Sinopec lost money for each barrel of oil its subsidiaries refined – this is because they had to pay prevailing oil prices but had to sell the resulting products at below cost. While the government partially compensated for this by giving the company subsidies, Sinopec's profits nevertheless failed to reflect the growing demand for its products. Furthermore,

the parent company can shift – and has shifted – monies from one subsidiary to another to improve balance sheets. The end result is that when you buy China Petroleum and Chemical Company or any other SOE, you really can not have a clear picture of the company in which you are investing – even if the financial press is touting its profitability and nice dividend.

How about private enterprises? Certainly these companies are not run for the benefit of the state or to further the goal of a harmonious society. On the other hand, some of these companies are not run for the benefit of shareholders, either. Rather, many privately-run enterprises are controlled by extended families – and these folks often look after their own rather than their shareholders' interests. And then there are the newer start-ups, companies like Baidu.com, the Chinese version of Google and Yahoo. The brainchild of Robin Li, a Chinese national who had emigrated to the U.S. as a computer science student and then worked as a programmer before returning to China, Baidu.com went public on NASDAQ on August 5, 2005 at \$27 a share and closed at the end of the day at \$122. While the share price leaped to three digits, so too did the multiple – and therein lies the problem with many of the new, so-called hot, Chinese private companies that are being listed on U.S. exchanges. While average valuations for Chinese stocks may be moderate, such is not the case for all Chinese equities.

The above does not say that one should avoid China SOEs or private companies; rather it emphasizes that you should be familiar with the risks associated with each kind of corporate structure before you buy. And if you plan to buy individual Chinese stocks, you will be buying either an SOE or a private company. As we will point out below, this implies that investors need to be broadly diversified and that most investors should consider only diversified portfolios of Chinese stocks, rather than individual companies.

A Short Primer on Mutual Funds

We believe that most investors will be better off participating in Chinese investments through mutual funds. These vehicles are very popular in the U.S. – an estimated 70 percent of all shares on U.S. exchanges are held by pension funds or institutions. Indeed, most investors in the United States own whatever domestic stocks they may have through mutual funds. It is nevertheless appropriate at this point to have a

brief primer on the different kinds of funds and their costs. Understanding the basic aspects of mutual funds will give you a clearer picture of the reasons for some of our recommendations in the following chapters.

All mutual funds package together a portfolio of stocks and then sell shares that represent interests in that portfolio. According to the Investment Company Institute, there are close to 8,000 different mutual funds offered for sale in the U.S., and their total value is close to \$10 trillion. They are wonderful instruments, giving even small investors an opportunity to buy fully diversified portfolios that can easily be bought and sold. Trying to sift through so many offerings, however, can make picking the limited number of Chinese funds appear to be a piece of cake! And fortunately, Chinese funds can be further narrowed down by being categorized by structure, costs, and focus.

Structure

One way to view an investment fund is to determine if it is “open-end” or “closed-end.” Open-end mutual funds issue and redeem shares in the fund at the net asset value of a share at the close of the market on the day of the transaction. They are “open” because the number of shares in the fund can increase indefinitely. When more money comes in, the managers use the funds to buy more stocks and thus create more shares in the fund. Open-end funds are not traded on stock exchanges; rather, the purchase and redemption of shares are all handled directly by the sponsoring company.

Closed-end funds generally do not issue or redeem shares after the initial offering. They are listed on exchanges and are bought and sold –like other stocks—at anytime during trading hours. The manager of the fund can trade stocks within the fund, but usually does not issue new shares after the initial offering. In contrast to shares in open-end funds which are priced at net asset value, the price of closed-end fund shares depends on what other investors are willing to pay for them and thus can be either above (known as a premium) or below (known as a discount) net asset value. The web site www.etfconnect.com gives daily updated data on the premiums and discounts of closed-end funds.

Focus

Mutual funds, both open and closed, come in all sizes and shapes. There are some that concentrate on large “growth” stocks, others that specialize in small “value” stocks, those that concentrate on commodities, and those that highlight specific industries or regions. One can name just about any area in which to invest and there is probably a mutual fund dedicated to that area. With regard to this book, there are geographical mutual funds that cover all emerging markets, mutual funds that specialize in Asia, mutual funds dedicated to each country surrounding the China periphery, and mutual funds dedicated just to China. There are also mutual funds that cover energy, gold, and raw materials.

Costs

It is important to recognize that most mutual funds are created for the benefit of the sponsoring companies and not for the buyers of the fund. And the sponsoring companies have made a lot of money from these funds – so much so that many fund management companies have actually gone public and sold shares in their operations. Open-end mutual fund managers generally reap riches by charging customers in two ways: by assessing a fee known as a load fee and by charging annual management and transaction fees, as well as marketing fees known as 12-b1 charges. These management costs make up the fund’s expense ratio, which shows the annual percentage of a mutual fund share price that is devoted to covering the expenses of the sponsoring firm.

With the 1973 publication of *A Random Walk Down Wall Street* and many other books and articles, the general public became aware of the onerous nature of the load fee and began to switch to no-load funds. No-load funds do not charge an initial fee. Both load and no-load funds, however, do assess annual management charges. The amount and extent of these charges vary dramatically from fund to fund. Some fund expense ratios can be as much as ten times that charged by other mutual funds. While closed-end funds, because they are traded on exchanges, do not assess a load fee (you do have to pay a broker’s commission to buy them), they do have management expenses that affect the net returns of the shares.

When those mutual funds that had been collecting great rewards through their loads saw their profits disappearing as customers switched to no-load funds, they came up with a clever scheme to partially disguise their loads. They created a class of shares known as A, B, or C shares; depending on which you buy, you can be charged either an up-front sales fee or a redemption fee when you sell, or both. As a result of all their various charges, mutual funds – over time – are rarely able to provide better results than the overall market. Indeed our advice is to avoid any fund that has a sales charge. Moreover, we favor funds that have relatively low annual expense charges.

Management fees as well as the transactions costs of buying and selling stocks tend to be considerably higher for international funds (and especially emerging market funds) than they are for funds specializing in U.S. stocks. It is far less costly to research the major companies in the United States than it is to do similar studies in foreign markets. Doing research on Chinese stocks is particularly challenging, and making transactions in small Chinese companies is far more difficult than trading shares of General Electric or Exxon-Mobil. Hence the expense ratios for emerging market funds tend to be higher than for U.S. domestic funds. This is even true for the low-expense index mutual funds and ETFs described below.

Index Funds and Exchange Traded Funds

Index funds are similar to open-end mutual funds in that they are not traded on exchanges but rather sold and redeemed by the sponsoring company. They differ markedly from open-end mutual funds in that they usually (but not always) have extremely low management costs and therefore relatively low expense ratios. Index funds, in fact, are often referred to as passive funds in that once a benchmark – such as the Standard and Poor's Index of 500 U.S. stocks (S&P 500) – is chosen and a portfolio of the shares in that index are put together, there is for all intents and purposes no further management involvement as far as stock selection goes.

Investors have flocked to index funds, investing hundreds of billions of dollars in these instruments over the years. Right after the concept caught on, however, some people began to quibble, pointing out that the S&P 500 only covered about three-quarters of all U.S. stocks traded in the market. What about the remaining 25 percent, they asked,

those future Microsofts and Googles that could be just starting out but were too small to make the top 500? More indexes rushed in to fill the gap. Today, there are indexes covering essentially the entire market (the Dow-Wilshire 5000), about 99 percent of the market (the Russell 3000), market sectors (technology, pharmaceuticals), commodities (gold, energy), kinds of companies (“value”, “growth”, high dividend paying), size of companies (corporate behemoths known as large caps and smaller firms called small caps), stocks in foreign countries or regions, and more. These index funds are sponsored by mutual fund companies and can only be redeemed at net asset value at the close of a trading day.

One class of index fund known as an Exchange Traded Fund (ETF) generally has extremely low expense ratios. As with all index funds, ETFs consist of a passively managed grouping of shares selected to meet specific criteria. The key difference is that ETFs can be bought and sold at any time during a trading day. They are somewhat similar to closed-end funds in that they can sell at a premium or a discount to their net asset value. Unlike regular closed-end funds, however, the number of shares in an ETF can be increased or decreased by redeeming the portfolio shares in kind or by delivering the basket of stocks making up the fund in exchange for ETF shares.

It is this creation and redemption of ETF shares that tends to keep the ETF selling at (or very close to) net asset value. For example, suppose the ETF sold at a premium over the value of the shares in the fund. An arbitrageur could then sell short the ETF shares and present the constituent shares (which had been purchased at lower prices) to obtain new ETF shares to deliver against the (short) sale position. Such an arbitrage would produce a guaranteed profit. Opposite arbitrage trades would be possible if the ETF sold at a discount from net asset value. ETFs also have an advantage over mutual funds in that they tend to be more tax efficient. When the ETF redeems shares in kind, taxable capital gains are not created for the holders of the ETF shares, even if the individual stocks delivered were purchased at lower prices. Sales of stocks by the ETF are not considered taxable events. As with index funds, there are all kinds of ETFs, and they cover a range of areas including broad markets, single countries, market sectors, and commodities. We feel that ETFs dedicated to China represent very attractive investments.

The Managed versus the Self-Directed Approach

If you've read this far and feel a headache coming on, you may well ask yourself: "Do I have time for all of this?" Or, perhaps, "Do I *want* to spend any time on this?" Since you're reading this book in the first place, it is a given that you are interested in investing in China. How far you take such interest is up to you and your priorities. We describe the various means of investing in China in the following chapters and we present our overall recommendations in the final chapter. In Chapter 9 we explain the way investors can buy Chinese companies through mutual funds and ETFs. In Chapter 10 we describe an indirect method of benefiting from the growth of China by buying groups of securities domiciled in other countries but which benefit from China's growth or by investing in the raw materials that China buys in increasing quantities as its growth continues. In Chapter 11, we look at how you might make or lose a lot of money by purchasing individual Chinese common stocks. In Chapter 12, which we call the Optimal Method, we recommend some lower risk and relatively easy and certainly cheaper methods for you to have your portfolio benefit from the growth of China without any further advice.

If you still feel, however, that you have neither the time nor the inclination to follow through on our descriptions and recommendations, you will have to hire a financial adviser to do the work for you. Even here, however, you are not scot-free as concerns time and certainly not as concerns money as advisers expect to get paid for the work they do for you. All good advisers should first review your capacity for and attitude toward risk and then recommend asset allocation. If they don't, fire them and get an adviser who can guide you through these essential activities before you begin investing. Thus, we conclude this chapter on preparation in presenting brief discussions of these two areas that every potential investor must explore.

The Crucial Matter of Knowing Your Risk Level

There's a saying that risk has its reward and this is certainly true in investing. The more risk you take on, the more money you can make – or lose. Hundreds of years of investment experience certainly stand as evidence of that investment truth. Common stocks have provided considerably higher returns than traditionally staid bonds. The

riskiest common stocks – such as those of smaller and start-up companies – have provided higher returns than those of larger, more established firms. But these larger returns have come at the expense of far greater risks. For example, portfolios of large U.S. companies (such as those making up the S&P 500 index) might, in a bad year, decline by 25 percent or more. Portfolios of smaller companies could lose 50 percent or more during bear markets. Thus, after accepting our argument that at least some China investments should be in your portfolio, you need to assess the degree of risk you are willing to assume or, to put it in more sober tones, the amount you can afford to lose and still maintain your financial and mental health.

Capacity for risk

Risk capacity involves the amount of risk you can assume without endangering either your financial stability or your ability to maintain your accustomed lifestyle. An individual's capacity for risk depends crucially on one's age. A salaried 30-year-old in good health has a far greater capacity for risk than a retired 70-year-old in poor health and with only modest means. A 30-year-old with a well-paying job can afford to suffer investment reverses for two major reasons. First, her lifestyle will not be affected by investment losses because her employment income will continue to provide the money needed for living expenses. Also, the 30-year-old investing for retirement will have many years to ride out the ups and downs of stock prices. There will be no requirement to liquidate portfolio assets during a bear market in order to fund necessary living expenses.

Contrast the situation of the 30-year-old with that of a person who is 70 or older, who is retired, quite possibly with some health problems, and who is counting on the investments in his retirement nest egg to provide for living expenses. For people meeting these criteria, investment reverses will undoubtedly affect their living standards. They have neither employment income nor long periods to ride out market reverses. They have very limited capacity for risk.

Attitude toward risk

Attitude toward risk has led many people astray because they can only think of the reward side of the equation. Let there be no illusions about the returns from equities. They come at the expense of considerable volatility. In October 1987, the U.S. stock market sank by 23 percent on a single day; in the first 19 days of the month almost \$1 trillion was lost. In a relatively short time period afterwards, from March 2000 to October 2002, the overall U.S. market declined by 40 percent. You think that's bad. Smaller companies, high-tech firms, and emerging-market stocks did even worse. In general, emerging markets tend to be twice as volatile as the U.S. market.

There are investors who literally get sick when experiencing such volatility and the loss (even if it is temporary) of a significant share of their investment portfolio. If you can't stand the heat – get out of the kitchen. If watching your portfolio decline at times by 30, 40 percent or more is unbearably painful, then cut back your allocation to equities. A friend of J.P. Morgan's once asked for advice about what to do with his stock portfolio because it was so volatile that he could not sleep at night. Morgan's response was swift and succinct: "Sell down to the sleeping point."

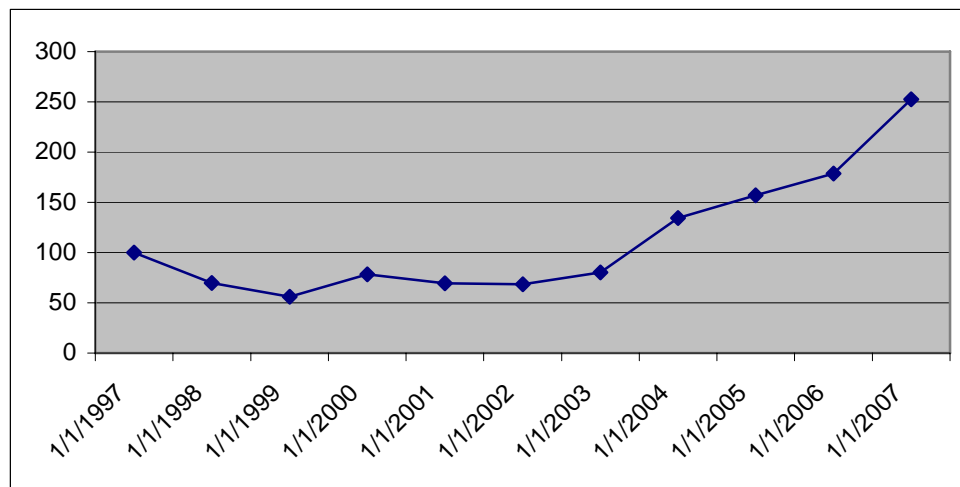
A Real Life Example

An actual example of how an investment in a successful Chinese mutual fund would have fared over a 10-year period provides a realistic picture of the riskiness of Chinese stocks. The fund is called the Templeton China World Fund and is run by Mark Mobius, an authority on investing in emerging markets in general and China in particular. The fund invests up to 80 percent of its assets in "China companies" defined as companies that derive at least 50 percent of their revenues from goods sold or produced in China, or have 50 percent of their assets in China. The companies may have their offices in the People's Republic of China or in Hong Kong or Taiwan. As China funds go, it is conservatively run.

Suppose you invested \$100 in the fund on January 1, 1997. By January 1, 2007 you would have been holding an investment worth over \$250 assuming that all dividends and distributions had been reinvested in the fund. Your average annual return would have been very close to 10 percent per year – certainly an attractive return. But you

would have endured a roller coaster ride along the way. Two years after you made your investment, you would have lost almost half your money as the fund's value declined sharply during 1997 and 1998. It took six and one half years before you broke even. Only if you had the capacity to ride out the storm and the stomach to endure consistent losses for months on end would you have been able to enjoy the benefits of the investment. Unfortunately most investors in the fund did not earn the generous 10 percent return the fund provided over 10 years. Most investors rush to put their money in after a big rise in the share price and they far too often sell out after a big decline has taken place. Exhibit 8.1 charts the results of a \$100 investment made in January 1, 1997. Don't invest in China unless you are prepared to accept similar volatility in the future.

Exhibit 8.1
Results From a \$100 Investment in the Templeton China World Fund
(Dividends and Distributions Reinvested)



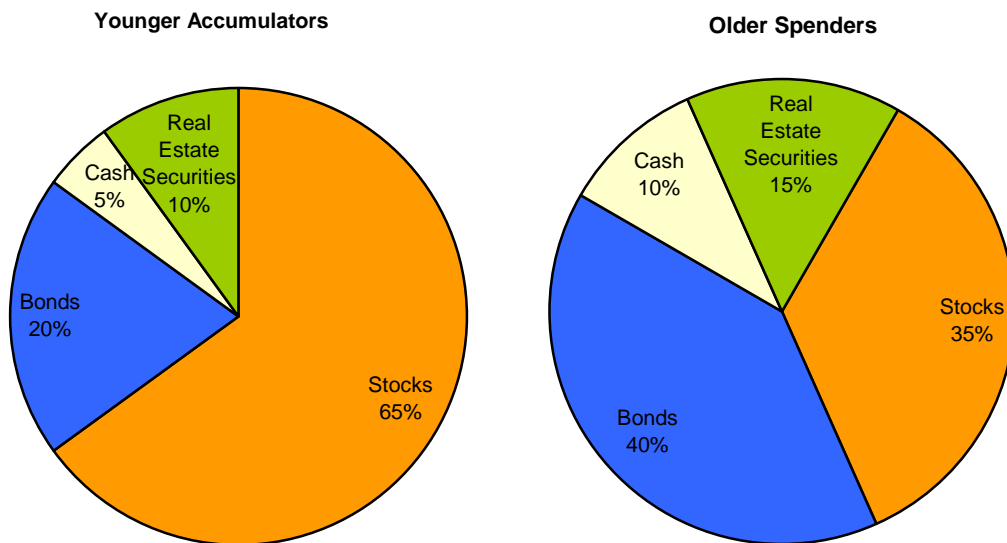
The Importance of Asset Allocation

Once you've matched your capacity for and attitude toward risk, it is time to review your asset allocation. This means that you review the entire spectrum of your investments – stocks, bonds, real estate, and cash – and then decided what percentage each should occupy within your total net worth.

Asset allocation by investment categories

Generally, asset allocation guidelines are constructed by four or five age groups, with those who are younger being able to take on more risk than those who are older. We present an even simpler scheme in Exhibit 8.2, in which we divide those with assets into two groups: the *accumulators*, who are generally salaried, younger adults, and the

Exhibit 8.2
Broad Age-Related Asset Allocation Charts



*Bonds include a diversified portfolio of corporate and mortgage bonds as well as Treasury Inflation Protection Securities.

spenders, who are generally older adults dipping into their retirement nest eggs. Many of the latter are, in fact, required by law to take withdrawals from their tax-deferred retirement plans. The basic idea behind these allocations is that the risk capacity for the accumulators is far greater than that of the spenders. Also, those living off their nest eggs need steady income; their equity portions should be tilted in the direction of common stocks that pay dividends. Obviously, different individual circumstances require adjustments to the above guidelines. A 75-year-old with substantial assets may wish to

give his assets to his children and grandchildren, and, therefore, his investment period will tend to be a long rather than short one so that a larger concentration of equities is appropriate. A 30-year-old couple may be saving to make a down payment on a house in a year or so, and thus a large concentration in equities is inappropriate. Monies set aside to fund major purchases such as a house or college tuition should be invested in safe bonds with a maturity that matches the date when the funds will be needed. In short, you should consider the allocations in Exhibit 8.2 as only rough guides that need to be adjusted for your needs and circumstances.

How China fits into the asset allocation picture

Basically, only stocks are available for those wishing to profit from China's booming economy. Currently, bonds are restricted to mainland residents and real estate investment opportunities are not only quite limited, as described in Chapter 7, but also generally speculative. By the process of asset elimination, the critical question we now need to address is "what percentage of the stocks in a portfolio should be invested in China?" Again, the fundamental principle of valuation must inform the answer: Risk has its reward. We believe Chinese equities are poised to provide higher returns than those available from stock markets in the developed world. But Chinese stocks are extraordinarily volatile – soaring up and plunging down more than twice as fast as U.S. stocks. Chinese market gyrations make fluctuations in North American and Western European markets look tame in comparison. How would you feel if the portion of your portfolio devoted to China declined by 50 percent? A 30-year-old with a stomach for risk-taking might reason, "I can ride it out – the long run looks rosy." But the 70-year-old, dependent on his portfolio for living expenses, is unlikely to be willing to accept such a risk.

What follows are some rough guidelines incorporating our suggestions regarding the proportion of an equity portfolio that we believe should be devoted to China. Remember that these are stated in terms of the proportion of equities – not the proportion of the total portfolio. Thus, if a portfolio consists of 50 percent equities and 50 percent bonds and we recommend that 10 percent of the equities be devoted to China, then only 5 percent of the total portfolio will be so allocated. Exhibit 8.3 presents our allocations.

Exhibit 8.3
Percent of Equities Allocated to China Strategy*

CAPACITY

A T T I T U D E		Low risk capacity	High risk capacity
	Willing to	5-10	15-20
	Assume the		
	Risk		
	Very Risk		
	Averse	0-5	5-10

*Numbers in Exhibit show the percentage of the equity part of the portfolio that should be devoted to a China strategy.

We are very bullish on the prospects for China. As explained in Chapter 12, the mixed strategy of direct and indirect investments that we will recommend as optimal somewhat reduces the overall risk of including China in your portfolio. Thus, for even the very risk-averse with little capacity for risk-taking, up to 5 percent of the portfolio equities could be devoted to a China strategy. For those who are less risk-averse and have a high capacity for risk, 20 percent of the equities in their portfolio can be devoted to China. Indeed, we are sufficiently bullish on China that we believe the greatest risk to any portfolio is to have China excluded altogether.

A Summing Up

China is the investment place to be, and we believe that those who invest now will be generously rewarded in future years. But before you commit your money to Chinese enterprises, you need to have some basic understanding of their structure. That's what

we have attempted to do in this chapter. Never forget that Chinese companies march to a different tune than American companies. Many are controlled by the government and others are beholden to closed circles of family members. Still, there is and has been a lot of money made from these firms as they participate in China's booming economy. Most important of all, become aware of your risk tolerance and how your assets are allocated. And perhaps it might also be wise to remember the Wall Street adage: "There are bulls and there are bears, but pigs get slaughtered." If you think Chinese investments are the way to get rich quick, with all gain and no pain, you may be in for a rude disappointment.

Now that you have completed your preparation requirements for investing in China, it's time to describe specific investment strategies to meet your personal objectives and situation. We do this in the following chapters.

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BGM;11/15/06
PT;11/20/06;3974
BGM; 11/29/06; 4384
PT;1/05/06;4383
BGM; 1/11/07 4285
PT; 1/17/2007; 4599
BGM;1/30/07;4885
BGM;2/13/07;4944
BGM;2/15/07;4945

Chapter 9: The Home-Grown Method

“There’s no place like home.”
-- last line in the movie, *The Wizard of Oz*

Those who have read every word to this point will easily recall that the text is sprinkled with the words “hundreds of millions of dollars.” These are the amounts that major corporations are pouring into China in order to profit from the country’s ever-expanding economy. They are also the words to describe the profits that many institutional investors have made through investing in Initial Public Offerings (IPOs) and in taking equity positions in China’s companies four and five years ago. Goldman Sach’s record in this regard is hard to beat; it reaped billions - that’s billion with an “s” – for its part in taking the Industrial and Commercial Bank of China public in 2006. Without question, the most profitable way to tap into China’s riches is to invest directly in the country and its enterprises, and that’s what the so-called “big guys” are doing.

But, as has also been repeatedly emphasized throughout this book, risk has its reward. While large corporations routinely make bad investing decisions, they can employ battalions of public relations specialists to put a positive light on such losses or bury the bad news in a wad of statistics that are appended to annual reports. Individual

investors, the so-called “little guys” like us, do not have such options. For the individual, investing directly in China is fraught with peril, the peril of losing a lot of money.

We have taken two approaches to investing directly in China. In this chapter, The Home-Grown Method, we cover a range of funds that own shares in Chinese companies. Through the diversification that these funds offer, we believe that this is the most prudent way for individuals to make direct investments in Chinese securities. In Chapter 11, The Go for Broke Method, however, we describe how investors with the stomach for assuming risk, might purchase stocks in individual Chinese companies.

Because of the unique nature of the Chinese stock market – the local market is closed to most outside investors – we have divided this chapter into two major parts. The first part presents our investment recommendation for those with access to the Shanghai and Shenzhen markets. The second part describes how to profit from China’s economic boom through ownership of Chinese equities listed on markets outside mainland China.

Shares Traded on Shanghai and Shenzhen Markets

As explained in the previous chapter, mutual funds can be broken into two categories: open-end and closed-end. Both are available in mainland China. Open-end mutual funds are not traded on stock exchanges but are rather sold by a sponsoring company at a price equivalent to the net asset value (NAV) of the shares at the end of the trading day. All sorts of fees – detrimental to your profits – can be attached to such funds. Even so, within the mainland China exchanges, the open-end mutual funds investing in so-called “A” shares, i.e., those listed on the Shanghai and Shenzhen stock exchanges, have handily beaten broad market indices. We attribute this to the indigenous knowledge of the Chinese fund managers as to which companies are corrupt and particularly risky and which ones are not. Exhibit 9.1 summarizes the information presented in Chapter 5 on the efficiency of the Chinese market.

**Exhibit 9.1 Managed Equity Funds in China Versus Local Share Indexes
1998-2006**

	Return of Managed Funds	Return of Shanghai Stock Index	Return of Shenzhen Index
Average Annual Return	20.75%	16.20%	16.20%

Return is considered the return of the equity portion of the managed fund portfolio. Included in the calculation are the returns from all open and closed-end funds that are restricted to buying local shares.

It is unfortunate that many individual investors in China have considered – not without reason – their stock markets to be little more than gambling casinos, with speculation the main performance feature. The taint of corruption has also been associated with several fund managers. While this is changing, with increased monitoring by the exchanges themselves and with regulatory crackdowns, selecting a good mainland-based mutual fund can be a bit tricky. In Exhibit 9.2, we present a sample of actively managed open-end mutual funds that have enjoyed excellent records and have scandal-free managements. Several are jointly managed by local companies and well known international financial institutions, such as J.P. Morgan, Invesco, and ABN AMRO. We believe that individual investors in China will be better served by owning a managed fund than by attempting to pick stock-market winners themselves.

Exhibit 9.2

Selected Chinese Open-end Equity Mutual Funds Holding A Shares

Fund Name	Net Asset Value (NAV) 12/30/06 (Yuan)	2005-2006 Trailing NAV Growth (%)	Morningstar Rating (Jan. 2007)
FUGUO TIANYI VALUE (Code 100020)	1.529	167.43	5
E FUND STRATEGY GROWTH (Code 110002)	2.469	151.28	4
SHANGHAI TRUST-JP MORGAN CHINA ADVA (Code 375010)	2.328	169.99	5
INVESCO-GREAT WALL DOMESTI C GROWTH (Code 260104)	2.836	182.20	5
HARVEST GROWTH (Code 070001)	1.968	125.78	3
GUANGFA JUFU (Code 27001)	1.997	129.74	3
FORTIS-HAITONG (Code 519011)	2.050	118.13	3
ABN AMRO-TEDA (Code 162202)	2.307	137.82	4

Source: Boser Fund Management Company

There is, however, an even better strategy available for investors with access to the A-share market. When available at substantial discounts, managed closed-end investment companies are preferable vehicles to profit from the A-share market.

As discussed in Chapter 8, closed-end funds are bought and sold on stock exchanges and can sell at a premium or a discount to their NAV. We are very much in favor of buying closed-end funds at a discount because any time an investor can buy a portfolio of common stocks at a discount, that investor can potentially obtain a return that will exceed the return earned by the portfolio. While this does not hold if the discount widens, it is true even if the discount does not disappear or narrow. Suppose an investor bought a common stock portfolio worth \$100 and paying a \$3 dividend but could buy the portfolio for only \$60 – a discount of 40 percent. Even if the discount stayed at 40

percent until the time the investor sold the shares, such an investor would earn an enhanced return. Buying the fund at \$100 NAV would produce a 3 percent return from the \$3 dividend. (We ignore any growth in the value of the shares.) But the buyer of the discounted fund at \$60 gets a 5 percent return: $\$3/\$60 = 5$ percent. Investors can enhance their returns by buying assets at a discount.

The advantage of buying mainland China closed-end funds at a discount is even greater. The funds we recommend have provisions to be liquidated at a specified future date. When the fund is liquidated it will sell all its holdings (or become an open-end fund) and redeem the outstanding shares at NAV. Several funds in the table below have liquidation dates as early as 2014. Thus, investors will not only get the advantage of an augmentation of the dividend yield of the fund, but also the extra return when the fund is liquidated at full NAV. In Exhibit 9.3 we show a number of heavily discounted large closed-end funds run by reputable investment management companies. For mainland Chinese or those international investors who can exercise QFII quotas, these funds represent an extraordinarily good buy.

Exhibit 9.3

Chinese Closed-End Funds Selling at Deep Discounts (01/01/2007)

Name	Price (Yuan)	Scheduled Liquidation Date	Discount (%)	Market Cap (100M Yuan)	Investment Objective
Hongyang	1.25	December 9, 2016	-29.15	25.00	G&V*
Tongqian	1.25	August 28, 2016	-28.04	25.00	Growth
Jinghong	1.484	May 5, 2014	-27.09	29.68	Growth
Hanxing	1.116	December 20, 2014	-26.47	33.48	G&V*
Tongsheng	1.338	November 5, 2014	-26.45	40.14	Value
Jingfu	1.445	December 30, 2014	-25.60	43.35	G&V*

Source: Boser Fund Management Co; Lipper:

*M&A = Mergers & Acquisitions; G&V = Growth & Value

A warning is in order, however. Investors should be aware that the discounts on these closed-end funds are highly variable. When Malkiel, Mei, and Yang (2005-2006) first recommended the strategy of buying discounted closed-end funds, the discounts ranged between 40 and 50 percent. At the time this book goes to press, discounts range between 20 and 30 percent. One of the paradoxes regarding investment advice is that when people act on a recommendation, they tend to diminish its value. No purchases of closed-end funds should be made unless discounts remain substantial.

This is true both for mainland and international investors. In September 2006, for example, Morgan Stanley used its QFII quota to introduce a closed-end fund on the New York Stock Exchange that consisted primarily of equities sold on the Shanghai and Shenzhen exchange. This was the first time that outside investors could easily access the mainland China stocks through a U.S. exchange. At the time the fund came out, news about the meteoric rise of the mainland markets was just beginning to spread. As shown in Exhibit 9.4, the MS China A Share fund (ticker symbol CAF) took off two months after its inauguration and rose 50 percent within three months. At the start of 2007, however, the market became nervous about the steep rise in the mainland markets and widespread selling took place. Within the space of a week or so, CAF lost 10 percent of its value – and not only that, in its first four months of existence, it has gyrated from a premium of 16 percent of net asset value to a discount of 6 percent. This fund should not be purchased by U.S. investors unless it is selling at a discount from its net asset value.

Exhibit 9.4

MS CHINA A SHARE FUND INC
as of 30-Jan-2007



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<http://finance.yahoo.com/>

This leads us to a second warning. The Chinese stock market is extraordinarily volatile. In 2006, for example, the market was one of the best performing in the world. Markets are suspect to inexorable tendencies to revert to the mean. A strategy of making commitments to Chinese equities gradually over time (rather than all at once) will lessen the chance that you buy in at the top of a period of euphoria.

Shares Traded on International Markets

Some of the companies that are listed in the A-share market are also listed internationally. Indeed, in 2006, 24 companies with a total market capitalization of over 600 billion yuan had shares traded in both the mainland and Hong Kong share markets, which is open to international investors. And, as explained in Chapter 4, other top-notch Chinese companies are not listed in the mainland exchanges but only in international exchanges such as those in Hong Kong, New York, and London.

There is convincing statistical evidence that the large Chinese companies listed in Hong Kong and New York tend to be stronger and better companies than those listed in Shanghai and Shenzhen. Exhibit 9.5 supports this finding. The top part of the exhibit shows that the average 9.5 percent annual earnings growth rate for an index of A shares, though quite respectable, lagged behind the earnings growth rate of both the Hong Kong traded shares (as represented by the FTSE/Xinhia index of 25 H shares) and the shares of

China companies listed on U.S. stock exchanges. Both the Hong Kong and U.S. listed shares enjoyed earnings growth over three times as fast as the growth rate for the domestically listed shares.

Another way to compare the attractiveness of companies is to look at the Return on Equity (ROE), which is the ratio of company earnings to the stated value of the equity invested in the business. The bottom half of exhibit 9.5 shows that the ROE for shares listed outside mainland China exceeded the ROE for mainland listed shares. Without question, the most profitable and fastest growing Chinese companies list in Hong Kong and New York, thus allowing international investors easy access to these companies for portfolio investments.

Exhibit 9.5

The Better Companies Have Listed in Hong Kong and New York Earnings Growth has Lagged for A Shares

	Annual earnings growth of A Shares (%)	Annual earnings growth of FTSE China 25 (%)	Annual earnings growth of ADRs (%)
One Year-2005	3.24	22.47	20.36
2003-2005	18.91	37.10	35.40
2000-2005	9.49	30.45	31.68

Return on Equity is Lower for A Shares

Date	ROE of Shanghai A Shares	ROE of FTSE 25 Shares	ROE of ADRs Shares
2005	9.01%	18.94%	18.37%
2003-2005	12.02%	16.06%	16.41%
2000-2005	9.67%	14.55%	16.36%

Source: Boserá Fund Management Co.

The bottom line, then, is that dollar-denominated mutual funds focused on China offer a double bonus: they are easy to buy and they are composed of the better China companies, those that trade on the Hong Kong and New York markets. And, as with all mutual funds, they offer investors a diversified portfolio that helps to minimize investment risk. Based on relatively low expense ratios and reasonable past performance, we have selected seven no-load open-end U.S. mutual funds for individual investors; these are shown in Exhibit 9.6. The expense ratios are higher than is typical for mutual funds investing in U.S. securities because of the added expenses of research in foreign countries and the higher trading costs in buying shares in markets such as Hong Kong.

Exhibit 9.6

Open-End, No Load U.S. Mutual Funds Investing in Chinese Securities (January 2007)

	Morningstar Rating	Expense Ratio %	Assets (\$M)	Trailing 5-Year Returns Av. Annual (%) (1/2002 – 12/2006)
Alliance Bernstein Greater China	★★★	2.02	100	22.26
Columbia Greater China Z	★★★★	1.47	230	22.99
Dreyfus Premier Greater China	★★★	1.88	463	24.12
Fidelity China Region	★★★	1.12	909	14.92
Templeton China World	★★★	2.06	858	N/A
Guinness Atkinson China	★★★	1.63	143	18.44
Matthews China	★★★	1.30	801	22.24

Source: <http://quicktake.morningstar.com/fund>; <http://finance.yahoo.com>.

While China-focused, closed-end funds that are listed on American exchanges have neither set liquidation dates nor the extremely large discounts of the Chinese closed-end funds, they can represent an advantageous purchase when they are selling at substantial discounts. These funds often hold shares trading on the Hong Kong Stock Exchange, shares which are extremely difficult for individual investors to buy through a U.S. broker. And even when a broker can be found, the minimum order as well as the costs of buying Hong Kong shares can be extremely high. And remember also that, as with all funds, closed-end funds provide diversification benefits. In the case of the Templeton Dragon Fund, for example, you are purchasing not only a portfolio of stocks of Chinese companies but also a stake in Chinese property development companies when you buy a share of the Fund. The www.etfconnect.com web site presents data on 13 closed-end funds focused on China and updates daily their discount or premium to NAV. On a recent day, for example, the discounts ranged from a 9 percent discount to a 29 percent premium. The Closed-End Fund Association at www.cefa.com also provides information on several more funds with large concentrations of Chinese investments.

In Exhibit 9.7 we list four closed-end funds that have been selected on the basis of their past performance and relatively low expense ratios. The data here are at the beginning of 2007. Do not buy any closed-end fund at a premium. For example, the Greater China fund at a 29 percent premium should be avoided, however well it has done in the past. Only buy funds at discounts. These premiums and discounts vary substantially from day to day. You can obtain current data by going to one of the websites mentioned above. If these closed-end funds are selling at only tiny discounts (less than 5 percent) or at premiums, you should buy open-end funds instead. The reason is that the discount could widen in the future and the investor's return would then suffer.

Exhibit 9.7
Closed-End U.S. Funds
(January 2007)

	Price	Morningstar Rating	Premium/Discount	Expense Ratio %	Trailing 5-Year Returns Av. Annual (%)
Jardine Fleming China Region (JFC)	22.55	★★★	-1.18	2.08	23.12
Greater China (GCH)	31.00	★★★★	28.9	2.09	23.09
China Fund (CHN)	32.70	★★★★	-1.14	1.38	26.91
Templeton Dragon (TDF)	24.96	★★★★	-8.63	1.52	31.73

Source: <http://quicktake.morningstar.com/fund>; <http://finance.yahoo.com>

Index Investing: Three Popular Indexes

We did not recommend investing in index investments in the local A-share market. As described in Chapter 8, index investing is a passive, low-cost method of profiting from efficient stock markets. The key word is *efficient* and, as we noted in Chapter 5, the mainland China share markets have yet to behave in an efficient manner. We did note in Chapter 5, however, that the Chinese share markets in Hong Kong and the U.S. are reasonably efficient. Therefore, index investing, either through mutual funds or exchange-traded funds, is a reasonable strategy for investors looking for a low-cost diversified way to access the stocks of Chinese companies traded in world markets. As this book goes to press, there are three widely recognized indexes, each varying to some degree, which are the basis for funds that can be bought to tap into the riches of China.

Hang Seng Index

The benchmark of the Hong Kong stock market, the Hang Seng Index is one of the best-known indexes in Asia and is widely used by fund managers as their

performance benchmark (much as U.S. managers used the Standard and Poor's 500 stock index as their benchmark). The Index consists of 36 companies, which account for about two-thirds of the total market capitalization of all stocks listed on the Hong Kong exchange. You can check on the daily performance of the index by going to Yahoo Finance and typing in '^HSI' in the *Get Quotes* box. Generally, when the financial press reports on the Hong Kong market, it is basing the market's performance on that of the Hang Seng Index.

Some of the companies in the Index are not listed on mainland China exchanges. Companies that are listed on the mainland as well as in Hong Kong must have completed their share reform in order to be included in the Index; thus, Sinopec, which completed its share reform in summer 2006, was not included in the Index until fall 2006. In addition, the financial performance of all companies is carefully scrutinized before they are included in the Index. HSI Ltd., which constructs the Hang Seng Index, also offers many other indexes derived from the Hong Kong Stock Exchange. Among these is the Hang Seng Composite Index, which includes 200 companies that account for about 90 percent of the Exchange's market capitalization.

While there are several Hang Seng ETFs that trade on the Hong Kong Stock Exchange, these are not readily available to U.S. investors. The U.S.-based State Street Global Advisors does offer its large clients a Hang Seng Index Strategy, in which the firm will purchase each security in the same capitalization weight as it appears in the Index. And truly sophisticated investors – some might wish to use the term high-flying gamblers – can also buy and sell Hang Seng futures online through www.xpresstrade.com. But most investors wishing to purchase an indexed portfolio of Chinese stocks will have to do so through one of the ETFs described below.

MSCI Hong Kong Index

There is a Hong Kong stock index that is easily accessible for purchase by international investors. Morgan Stanley Capital International, Inc. (MSCI) is an international leader in the creation of market indices. The firm's global equity benchmarks are the basis for an annual \$3 trillion in sales. The firm has constructed several for China, Hong Kong, and the China periphery. The one most pertinent to this

book is the MSCI Hong Kong Index, which covers most of the stocks traded on the Hong Kong Stock Exchange. It is the basis for the Fidelity China Fund and for the iShares MSCI-Hong Kong Index ETF (ticker symbol EWH) described below.

FTSE Xinhua China 25 Index

FTSE Xinhua Limited has also created several China-centered indexes. This firm is a joint venture of FTSE, an independent company owned by The Financial Times and the London Stock Exchange, and Xinhua Finance Limited, a Hong Kong based financial services and media company,. One of their indexes, the FTSE Xinhua Hong Kong Index, is the benchmark for China's Social Security Fund.

The most widely known is the FTSE/Xinhua China 25 Index; it is the basis for an ETF traded under the ticker symbol FXI. This consists of the 25 largest and most liquid – without regard to share reform -- Chinese stocks trading on the Hong Kong Stock Exchange. Thus, Sinopec, was included in the Index before its share reform was completed. In a further differentiation from the Hang Seng Index, which is a market capitalization index (the larger the company, the greater its weight), the FTSE/Xinhua China 25 Index caps individual constituents at 10 percent in order to avoid over concentration in any one stock. The holdings are reviewed quarterly and adjusted accordingly with regard to concentration. Even with this periodic rebalancing, however, FXI is a relatively concentrated index with the top ten holdings accounting for approximately 60 percent of the index's total capitalization.

Three ETFs

Exchange traded funds (ETFs), described in Chapter 8, have proven to be a low-cost, extremely popular vehicle for investing in a wide number of areas. The following describes three China-centered funds that trade on U.S. exchanges.

EWH ETF

This is the oldest of the China-centered ETFs, having been introduced on March 12, 1996. It is widely known by its ticker symbol, EWH, rather than its long-winded official name of iShares MSCI-Hong Kong Index Fund. That official name, however,

tells you the name of the index on which the Fund is based. As such, the Fund holds China-based companies that are incorporated in Hong Kong, rather than companies, such as China Mobile, that are incorporated in China itself. However, many of the companies in the index such as Hutchison Whampoa do most of their business in China. And, yes, that is the Esprit apparel and housewares company listed among the top ten holdings. A true representative of the global economy, Esprit was founded in San Francisco, is headquartered in Ratingen, Germany, and is listed on the Hong Kong Stock Exchange (with a secondary listing on the London Stock Exchange), where its Financial and Investor Relations offices are located.

Of the three funds reviewed here, EWH has the highest trading volume – well over 1 million shares a day – as well as the highest dividend payout. Alas, as of 2007, it also has one of the lowest total returns. However, though the return was low compared to the other two ETFs reviewed here, it still outperformed all U.S. stock market averages during the 2005-2006 period. In contrast to the other two ETFs, EWH is heavily concentrated in Hong Kong property development companies, companies which are recording huge profits from their activities in mainland China. For those who would like to take a conservative position in China's real estate market, this ETF would be an appropriate choice. Indeed EWH is one of the few feasible ways for international investors to take a position in Chinese property companies.

Exhibit 9.8
Top 10 Holdings of EWH
(January 2007)

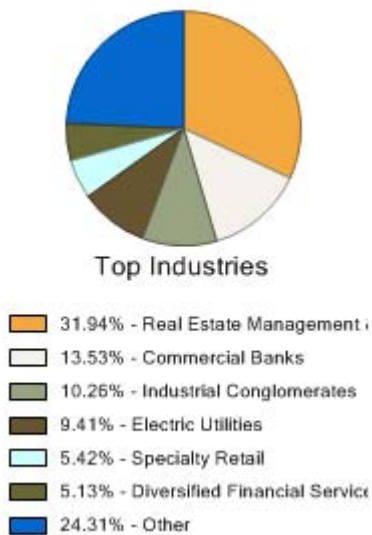
Name	% Net Assets
Hutchison Whampoa Ltd.	9.48%
Cheung Kong (Holdings) Ltd.	8.18%
Sun Hung Kai Properties Ltd.	6.89%
CLP Holdings Limited	5.83%
Hong Kong Exchanges & Clearing Ltd.	5.13%
Esprit Holdings Ltd.	5.06%
Hang Seng Bank Ltd.	4.57%
Bank of China (Hong Kong) Ltd.	4.40%
Swire Pacific Ltd.	4.37%
The Bank of East Asia Ltd.	3.67%

% of assets in top 10 holdings **57.58%**

SOURCE : MarketWatch from Dow Jones

Industry Diversification

As of 12/31/2006



FXI ETF

On October 4, 2004, Barclays Global Investors introduced the iShares FTSE/Xinhua China 25 Index Exchange Traded Fund. Fortunately for all concerned, this fund quickly became known by its simpler name as the FXI ETF and, indeed, its New York Stock Exchange ticker symbol is FXI. As the name implies, this ETF closely follows the FTSE/Xinhua China 25 Index.

We recommend the FXI exchange traded fund as an excellent method to gain easy access to Chinese shares available to international investors. FXI also allows international investors the opportunity to participate in companies that are only listed on the Hong Kong Stock Exchange. It is extremely difficult, for example, for international investors to purchase shares in COSCO Pacific Ltd., a huge container-related shipping conglomerate, because the company is only listed on the Hong Kong Stock Exchange. When you buy FXI, however, you are buying a piece of COSCO Pacific Ltd, as well as a portion of 24 other major Chinese companies.

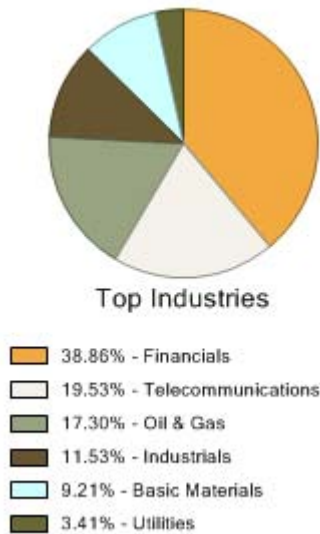
Exhibit 9.8
Top 10 Holdings of FXI
(January 2007)

Engines of Growth

Name	% Net Assets	Sector				
PETROCHINA	8.78	Oil & Gas				
CHINA LIFE INSURANCE	8.63	Financials				
INDL AND COMMERCIAL BANK OF CHINA	8.44	Financials				
CHINA MOBILE	7.85	Telecommunications				
BANK OF CHINA	5.80	Financials				
PING AND INSURANCE GROUP	4.83	Financials				
BANK OF COMMUNICATIONS	4.65	Financials				
CHINA TELECOM	4.41	Telecommunications				
CHINA CONSTRUCTION BANK	4.23	Financials				
CHINA SHENHUA ENERGY	4.16	Oil & Gas				
% of Assets in Top Ten Holdings	62.07%					

Industry Diversification

As of 12/31/2006



Note that over 70 percent of the FXI ETF is concentrated in Financials, Telecoms, and Energy. This gives it a quite different composition from the EWH ETF described above.

PGJ ETF

On December 9, 2004, just two months after the FXI ETF debut, the PowerShares Golden Dragon Halter USX China made its appearance; mercifully, this mouthful is widely known by its ticker symbol, PGJ. The structure of PGJ differs significantly from that of EWH and FXI in that it only includes U.S. exchange-listed companies that derive a majority of their revenues from mainland China. Thus, you do not own a piece of COSCO Pacific Ltd. or any other company listed only in Hong Kong when you buy PGJ. PGJ also differs from FXI in that it is a much broader ETF and includes over 50 companies in its holdings.

PGJ differs from the above two ETFs in another aspect, this one detrimental to PGJ. PowerShares, the PGJ sponsor, argues that its ETF is a safe way for U.S. investors to get exposure to China because it only includes stocks listed on U.S. exchanges. But PGJ has its critics as well. Not all of the PGJ stocks are traded on the New York Stock Exchange or the NASDAQ market; some are thinly traded in the over-the-counter or

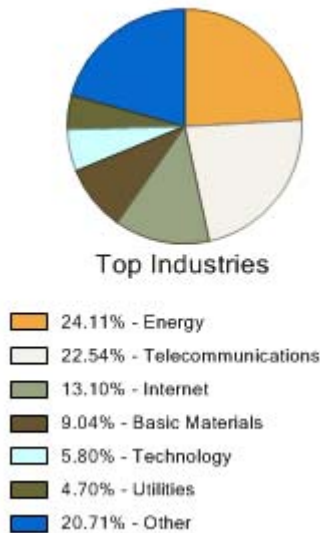
“pink sheet” markets described earlier. And some of the issues in the index—and indeed the poorest performers—were formed by mergers engineered by Tim Halter himself, the creator of the index on which PGJ is based. To make matters worse, financial journalists from *Barron’s* and *The Wall Street Journal* have suggested that Halter’s firm sold some stocks right after inclusion in the index boosted their prices. While the conflict of interest suggestions are troublesome, the stocks associated with Halter constitute only a small fraction of the total holdings in the index. Halter has also suggested that rules are now in place that will prevent any future conflicts from occurring.

Exhibit 9.9
Top 10 Holdings of PGJ
(January 2007)

Name	Ticker Symbol	% Net Assets	Sector
China Mobile	CHL	6.19%	Telecommunications
PetroChina Company Ltd.	PTR	6.16%	Oil & Gas
Sinopec	SNP	4.97%	Oil & Gas
China Telecom Corp.	CHA	4.96%	Telecommunications
China Life Insurance	LFC	4.83%	Financials
Aluminum Corp. of China	ACH	4.75%	Industrial Materials
SunTech Power Holdings	STP	4.68%	Utilities
Huaneg Power International, Inc.	HNP	4.59%	Utilities
China Unicom Ltd.	CHU	4.57%	Telecommunications
China Netcom Group Corp	SNP	4.32%	Telecommunications
% Assets in Top Ten Holdings		50.02%	

Industry Diversification

As of 11/30/2006



PGJ has the advantage of including a larger share of technology companies than the other two ETFs. While the PGJ ETF has not performed as robustly as the FXI ETF, it did outperform the EWH ETF. All three have handily outperformed the Dow, S&P, and NASDAQ benchmarks in recent years.

A Summing Up

In this chapter we have presented practical strategies that enable investors to build portfolios of Chinese companies. For those with access to mainland China, managed closed-end funds represent the optimal strategy and are available at substantial discounts. Moreover, the closed-end funds we recommend have maturity dates when the funds are to be liquidated and the discounts will disappear.

Since many of the strongest and most profitable China companies trade on international exchanges, investors outside of China have broad opportunities for purchasing attractive portfolios of home-grown Chinese companies. Indeed, Chinese companies that trade in international markets appear to be more efficiently priced than those traded in local Chinese markets and at least the larger companies appear to be among the strongest Chinese companies available for investment.

Many investors will find that mutual funds and closed-end funds will provide an effective vehicle for gaining exposure to Chinese companies. The funds provide broad diversification and easy one-stop shopping. They can also enable the individual investor access to the Hong Kong stock market. Diversified funds are essential for investors who want to moderate the substantial risk involved in buying individual company stocks.

As this book goes to press, there are three ETFs focusing on China. The stocks in these ETFs sell at price-earnings multiples in line with those on world equity markets, but have considerably better long-run growth prospects. EWH is representative of the Hong Kong market, which includes many companies profiting handsomely from their mainland China activities, and has a large real estate exposure. FXI is representative of the 25 largest companies on the Hong Kong Stock Exchange, and PGJ covers a universe of U.S.-listed, China-based companies. While there are some definite issues with regard to the smaller holdings in PGJ, it has nevertheless handily outperformed U.S. stock averages in recent years. FXI's performance has been particularly outstanding. All three ETFs can play a useful role in giving investors exposure to the substantial continued growth we envision for the Chinese economy.

Word Count: 4,098
BGM: 11/25/06
PT; 12/14/06
BGM; 1/10/07
BGM; 1/24/07; 4,263
BGM;1/31/07;4659
BGM;2/09/07;4729
BGM;2/15/07;4710

Chapter 10

The Off-Shore Method

If GE's strategy of investment in China is right,
it is the future of the company for the century.

-Jack Welsh

We recognize that there are complications and complexities involved in direct ownership of Chinese common stocks. For example, one of our most highly recommended strategies, buying discounted closed-end Chinese investment funds with near-term liquidation dates, is only feasible for local investors and those international investors who have a QFII quota. Moreover, some investors in the United States and Europe may be reluctant to venture that far beyond their national boundaries. They may feel, correctly, that accounting statements in China are still relatively opaque and that corporate governance is not yet up to world standards. Nevertheless, even xenophobic investors who are impressed with the growth of China may well wish to participate in some way from the profitable opportunities China's growth is likely to generate. Such investors will find indirect methods of benefiting from China's booming economy useful adjuncts to their overall portfolio strategy.

In this chapter, we will show how investors can benefit indirectly from China's growth by employing a number of straightforward strategies. China's economic expansion has generated an unprecedented demand for raw materials. Thus, one indirect strategy to benefit from China's growth is to purchase raw materials and the companies that produce them. Other indirect investment strategies look to companies domiciled in countries such as Taiwan and Japan, whose fortunes are closely tied to China. Indeed, countries throughout Asia have benefited substantially from the economic success of China. Finally, we shall show that a subset of companies domiciled in the United States and Europe are deriving, and will continue to derive, enormous benefit from China's growth. This chapter will describe several practical indirect investment strategies whose results are importantly influenced by economic conditions in China.

China Soaks Up Natural Resources

China has, to a large extent, become the manufacturer to the world. The United States, with the largest economy in the world, became the world's largest exporter of goods in the 20th century. But China's exports have grown exponentially since the late 1980s. Chinese exports surpassed U.S. exports in dollar value during the final months of 2006. Exhibit 10.1 shows the development of China's exports as a percentage of U.S. exports from 1994 through 2006. By 2007, the value of China's exports exceeded that of the United States.

Exhibit 10.1



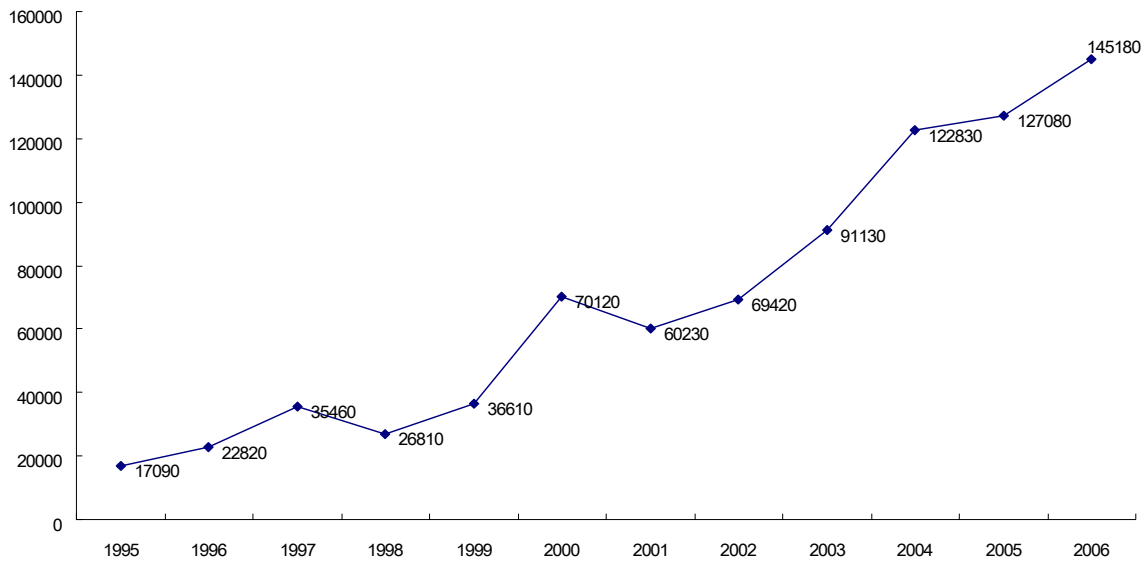
Source: Boseria Fund Management

The effect of China on the prices of manufactured goods is well understood. World manufacturers are considered to have “limited pricing power” because of competition from China. It is not an exaggeration to say, “If China can make it, its price is unlikely to rise.” But the corollary to that statement is even more relevant for us in devising strategies for benefiting from China’s growth. China imports many of the raw materials it needs in the manufacturing process. Thus, we can also say, “If China needs to buy it, its price is very likely to rise.” We believe that a major impetus to the price increases of raw materials since the late 1990s has been China’s demand for them.

Both the needs of the export sector as well as the increased consumption of China’s huge population have created a growing demand for commodities such as oil, timber, and other raw materials. China is already the world’s largest consumer of copper, using about 20 percent of the global supply – almost one and one half times as much as

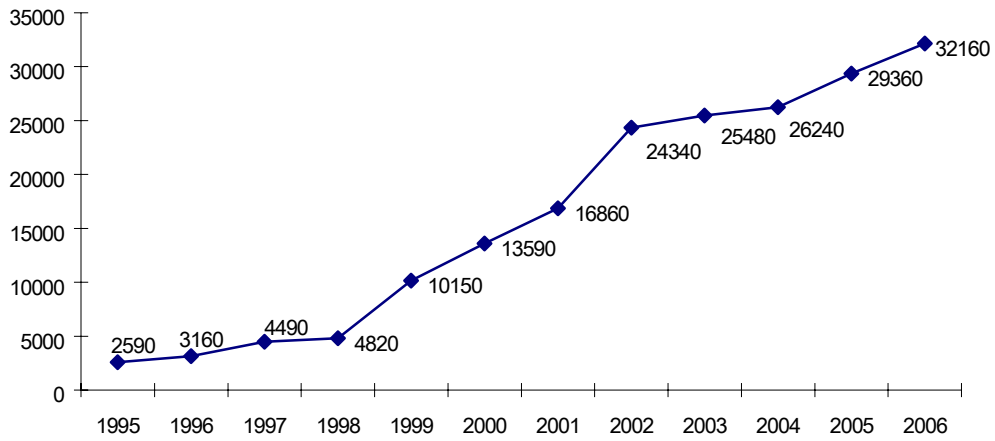
the United States. China consumes an equivalent proportion of the world output of wheat, corn, aluminum, and cotton. As a result of growing Chinese demand (as well as increased demand from other emerging economies such as India), the prices of many commodities have been on a record-breaking upward trajectory for the past 25 years. China's need for timber has been particularly strong. A logging ban was implemented on the Chinese mainland after 1998 because of the soil erosion problem caused by previous deforestation. The domestic supply is constrained, and over 100 million square feet of additional housing has been constructed for the 2008 Beijing Olympics alone. Exhibits 10.2 through 10.4 show the growth in the physical volume of Chinese imports of oil, timber, and coal. Similar charts can be shown for other raw materials. The growth of China has caused a burgeoning demand for raw materials and concomitant sharp increases in the prices of these minerals.

Exhibit 10.2
China's Imports of Crude Oil (in Tons)



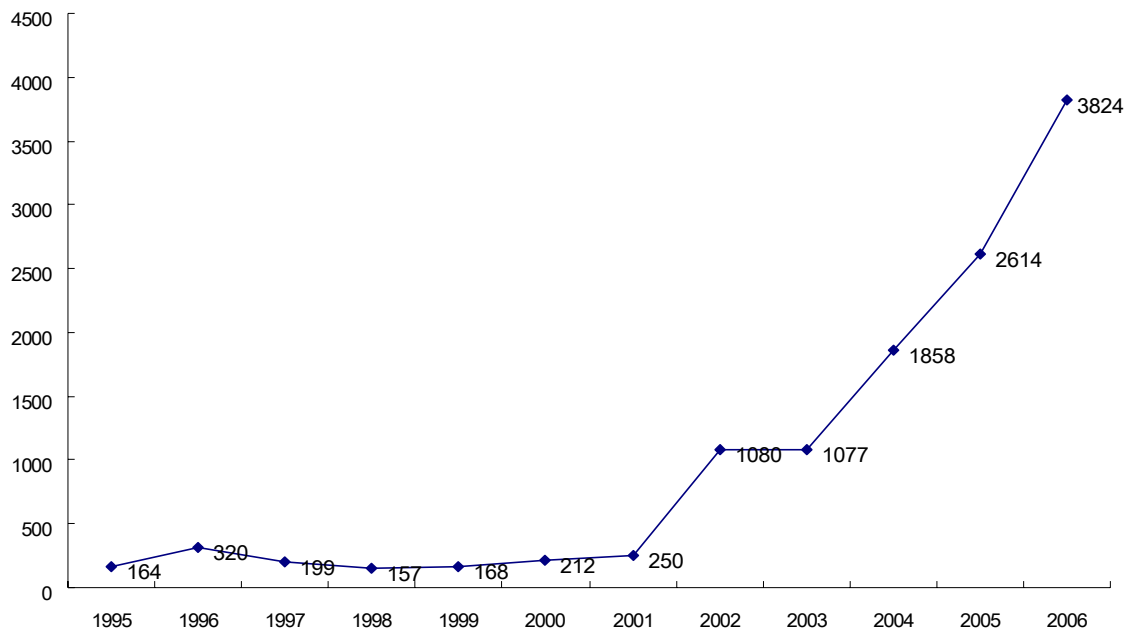
Source: Bosera Fund Mangement

Exhibit 10.3
China's Imports of Timber (in Meters)



Source: Bosera Fund Mangement

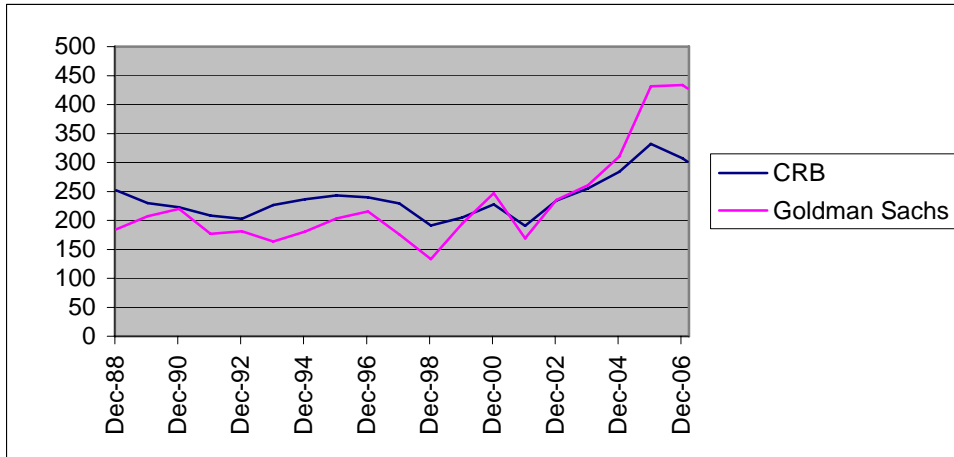
Exhibit 10.4
China's Imports of Coal (in Tons)



Source: Boser Fund Management

Exhibit 10.5 presents another illustration of the increase in commodity demand, and thus in commodity prices, since the late 1990s. The Goldman Sachs commodity price index, as well as the Commodity Research Board (CRB) price index, has risen sharply over the period. Owning instruments that rise with the increase in commodity prices is one indirect way to benefit from the growth of China. While commodity prices are extremely volatile, the continued growth of China is likely to put continuing upward pressure on these prices.

Exhibit 10.5
Goldman Sachs and CRB Commodity Indexes
1989-2006



Exposure to commodities also provides important diversification benefits. Recall that the lower the correlation between any two asset classes in a portfolio, the greater the potential for risk reduction. The greatest risk reduction comes from adding an asset class that has a negative correlation to an existing portfolio. For a U. S. investor whose holdings are concentrated in U.S. stocks, commodities are excellent diversifiers. During the early years of the 2000s, commodities have had a negative correlation with U.S. equities.

There is a commodity ETF available, trading under the ticker symbol GSC, that tracks the Goldman Sachs commodities index, which has a heavy weight in oil. A somewhat broader commodity ETF, trading under the symbol DBC, tracks the Commodity Research Board (CRB) index of commodities prices. Another commodity ETF is available, trading under the symbol GLD, that tracks the price of gold. We prefer, however, to invest in ETFs that hold shares in the companies that produce the commodities. The fortunes of the producers are largely aligned with commodity prices.

Moreover, the producers of commodities are profitable business who are able to distribute dividends to their shareholders. A sample of commodity producer ETFs is shown in Exhibit 10.6.

Exhibit 10.6

Selected Commodity Producer ETFs

	Ticker	Expense Ratio	Total Assets MM	Dividend Yield	Trailing 5-year Average Annual Return
Vanguard Energy	VDE	0.26	351	0.9	NA
Energy SPDR	XLE	0.25	3952	1.2	19.70
Vanguard Materials	VAW	0.26	109	1.4	NA
Materials SPDR	XLB	0.24	872	2.3	14.29
iShares Materials	IYM	0.60	459	1.9	12.83
SPDR Metal & Mining	XME	0.35	29	NA	NA
Gold Miners Market Vectors	GDX	0.55	349	NA	NA

Source: <http://quicktake.morningstar.com/fund>; <http://finance.yahoo.com>

(January 2007)

Exposure to commodities producers is an effective indirect method to benefit from the growth of China as well as other rapidly developing countries. While commodities and their producers have extraordinarily volatile returns and, therefore, are risky by themselves as investments, it is paradoxical but true that they can help reduce the overall risk of a portfolio because of their diversification benefits. All portfolios should have some exposure to commodities.

Taiwan Rides the China Dragon

Despite the acrimonious political rhetoric between the two entities, mainland China and Taiwan are becoming even more integrated economically. In 2006, for example, Taiwan interests on “the continent,” as the Taiwanese refer to the mainland,

accounted for approximately 15 percent of total Chinese exports, with percentages in the information technology hardware sector as high as 60 percent. Taiwanese investment in China now totals over \$50 billion, accounting for almost 70 percent of Taiwan's total outbound investment.

The Taiwanese government's efforts to dampen such a massive exodus, beginning with its "invest in Taiwan" policy in 2003, have done little to halt the flow of money and people out of the island. Approximately 1 million Taiwanese are now living and working in China. And Chinese government statistics indicate that over 70,000 Taiwanese companies have invested in mainland China. There are thousands more companies that have indirect financial interests in China through their investments in enterprises based in Hong Kong and Singapore.

Though Taiwan is the second largest high-tech chip manufacturer in the world, its role is increasingly one of design, management, and finance – with the manufacturing taking place on the mainland and the finance on the island. Increasingly, to the Taiwanese government's dismay, even much design is now taking place on the mainland. By expanding into China, many Taiwanese chip makers have achieved a potent mix of technology know-how, world-wide market access, and cheap labor, and they are very well positioned to meet the needs of a growing Chinese market as well as demand from around the world.

We feel that the best way to access the Taiwanese market, and thereby to benefit indirectly from China's growth, is through a diversified vehicle, rather than through the purchase of individual Taiwanese stocks. Two that are worth considering are the Taiwan Greater China Fund and the MSCI Taiwan Index. The first is a diversified closed-end

fund investing in Taiwan-listed companies that derive substantial profits either from exporting to or operating in mainland China. The fund's ticker symbol is TFC and it is listed on the New York Stock Exchange. But as with all closed-end funds, we recommend that you buy only if the shares are selling at a discount from their net asset value. The entire Taiwan market can be accessed through the ETF ticker EWJ, which tracks the MSCI Taiwan index.

Japan Jumps into the China Boom

No student of history can fail to ignore the bitter enmity between China and Japan. To this day, anti-Japanese protests are not uncommon in China, and a residue of ill will continues. But the simple truth is that the economies of China and Japan are highly complementary, and China has become Japan's third-most important trading partner after the United States and the European Union. China has become an important outsourcing center for Japanese companies as well as an increasingly important domestic market for Japanese products. Ordinary Chinese have more disposable income today than at any time in their history, and the middle class is growing rapidly. Contrary to popular belief, domestic demand, rather than net exports, contributed to over 80 per cent of China's 10.5 per cent growth during 2006, and much of that demand has been for Japanese-company owned goods.

The investment research department of Alliance-Bernstein has estimated that Chinese per capita income will increase on a scale not experienced since the industrialization of the United States, Japan, and Western Europe. Despite the unequal income distribution and concentration of wealth, we believe that currently 100 million

Chinese earn more than \$6,000 per year, which represents over \$20,000 per year in purchasing power. China already has a middle class that is about equal in number to the entire population of Japan. The steady growth of the Chinese middle class has created a significant demand for Japanese products. Moreover, low penetration rates, relative to countries such as Japan, in products such as mobile phones, TV sets and refrigerators leave much room for enormous future growth. Thus, Japan benefits from China's advantages as an important outsourcing center and serves as an important market for Japan's industrial and consumer products.

The investment firm of Goldman Sachs has put together a "China-Related Japan Stock Basket." The basket contains those Japanese stocks that benefit substantially from the growth of China through sales to China or by doing their manufacturing in China with its low-cost labor force. We believe that the growth of China has been responsible in large part for the ability of Japan to recover from over a decade-long recession following the real estate and stock market bubble that peaked at the start of the 1990s. China has been the major impetus to the growth of Japan's national income during the period from 2001 through 2006. More than half of Japan's exports to China consist of high value-added capital intensive products. The Goldman Sachs China basket of Japanese stocks has substantially outperformed the general Japanese stock index. Exhibit 10.7 lists the companies in the Goldman China-Related Japanese index.

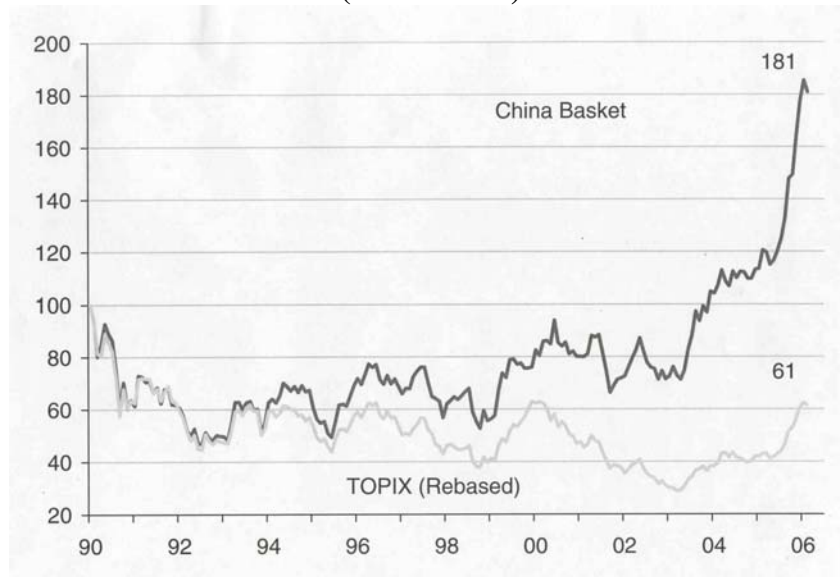
Exhibit 10.7

**The Goldman Sachs China-Related
Japanese 30-Stock Index**

Company	Industry	Company	Industry
Mitsubishi Rayon	Acrylic Materials	Daikin Industries	Machinery
Tosok	Chemicals	Hitachi	Electric Machinery
Asahi Glass	Glass products	Mitsubishi Electric	Electric Machinery
Nippon Steel	Steel	Matsushita Electric	Electric Machinery
Hitachi Construction	Construction Machinery	Sony	Electric Machinery
NSK	Automobiles	Fanuc	Electric Machinery
Koito	Auto Parts	Ricoh	Digital Copy Machines
Hochu Corp.	Food, textiles	Nissan Motor	Automobiles
Mitsui & Co.	Iron Ore	Toyota Motor	Automobiles
Mitsubishi Corp.	Coal etc.	Honda Motor	Automobiles
Dainippon Ink	Chemicals	Yamaha Corp.	Musical Instruments, etc.
Nippon Electric Glass	Glass Products	Nippon Express	Land Transport
Taekeiyo Cement	Cement	Nippon Yusen K.K.	Marine Transport
Toto Ltd.	Glass and Ceramics	Mitsui O.S.K. Lines	Marine Transport
JFE Holdings	Iron and Steel	Kawasaki Kisen Kaisha	Marine Transport

Exhibit 10.8 displays the performance of the Goldman China basket and the general TOPIX index of Japanese stocks.

Exhibit 10.8
Performance of the Goldman Sachs China Basket of Japanese Stocks
(1990 – 2006)



Source: Goldman Sachs & Co.

All of Asia Taps into China's Wealth

Countries throughout Asia have substantially benefited from China's growth. The Australian market has been very strong during 2005 and 2006 thanks to the Chinese demand for Australian raw materials and products. Similarly, Chinese growth has benefited South Korea, Malaysia, and Singapore. Real Estate Investment Trusts domiciled in Singapore have substantial and profitable property investments in mainland China. Exhibit 10.9 presents a listing of some open-end and closed-end funds (including ETFs) that provide Asian exposure and that have moderately low expense ratios. The broader Asian funds also provide some exposure to India, another emerging market with very attractive growth prospects.

Exhibit 10.9 Open and Closed-end Funds and ETFs with Broad Asian Exposure (Update to January 2007)

Open-end Funds

Fund Name	Morningstar Rating	Expense Ratio	Trailing 5-year Returns Av. Annual (%)
American Century Emerging Markets	★★	2.19	23.13
Fidelity Emerging Markets	★★	1.01	25.73
Vanguard Emerging Markets Index Fund	★★★	0.42	25.2

Closed-end Funds

Ticker	Fund Name	Morningstar Rating	Expense Ratio	Premium (+) Discount (-)	Trailing 5-year Returns Av. Annual (%)
APB	Asia Pacific Fund	★★★	1.78	-4.29	25.21
GRR	Asia Tigers	★★★	2.20	-3.18	24.71
GCH	Greater China	★★★	2.09	2.41	31.73
APF	Morgan Stanley Asia Pacific	Not Rated	1.17	-10.23	21.46
TFC	Taiwan Greater China	★★	2.12	-6.59	7.15
SGF	Singapore	★★★	1.86	-3.53	28.03
MF	Malaysia	★★	1.57	-5.10	17.24
KF	Korea	★★★	0.89	-3.65	26.06

Exchange-traded Funds

(Ticker)	Fund Name	Expense Ratio	Recent (52 week) Market Return
EWH	MSCI Hong Kong	0.54	32.81
EWT	MSCI Taiwan	0.85	17.86
EWY	MSCI South Korea	0.70	8.30
EWS	MSCI Singapore	0.54	48.30
EWM	MSCI Malaysia	0.54	45.61
EWA	MSCI Australia	0.54	29.30
EWJ	MSCI Japan	0.70	7.17

Many U.S. Companies Rely on China For Growth

Over 250 U.S. companies belong to an organization called the U.S.–China Business Council (USCBC). The Council, based in Washington, DC and with field offices in Beijing and Shanghai, exists solely to expand the commercial and economic ties between China and the United States. Both big and small businesses see high profits to be made from dealing with China. U.S. corporate profits in China passed \$2 billion the first six months of 2006, up more than 50% from the first half of last year, according to the U.S. Bureau of Economic Analysis. U.S. companies are on pace to earn more in China this year than they earned there during the entire 1990s, according to Joseph Quinlan, chief market strategist at Bank of America.

Wal-Mart purchased \$25 billion of merchandise in China in 2006 and has done more than any other company in the world to put “Made in China” on the U.S. retail landscape. If Wal-Mart were a country it would be China’s sixth largest export market. Wal-Mart also has considerable retail business in China. Indeed, “China will be as big and as successful a market for Wal-Mart as the United States, says Deutsche Bank analyst Bill Dreher. Wal-Mart is rapidly expanding in China, building many stores in urban population centers. The company has transformed the way Chinese suppliers operate, replacing a culture based on personal relationships with a supply network based on pricing, delivery, and product quality, all enabled by information technology. Chinese suppliers, accustomed to winning business by wining and dining their customers, have reported being shocked at Wal-Mart’s strictly by the numbers protocol. During 2006, Wal-Mart announced a \$1 billion acquisition of Trust-Mart, a Taiwanese-owned chain of

more than 100 “big box” superstores in China. Wal-Mart’s strategy is to grow up with China’s middle class, which is expected to quintuple to 200 million by 2015.

While China is investing heavily in its transportation infrastructure, its distribution system is still antiquated and inefficient. This gives U.S. companies such as UPS and Federal Express significant advantages. UPS and Fed Ex are still making heavy investments in their China networks. Their businesses in China are not yet profitable, but we believe investors will enjoy significant earnings gains when the network is up and running. ProLogis, which is a real estate investment trust (REIT), offers investors exposure to both China’s transportation industry and its real estate.

Americans seem to be losing their taste for Colonel Sanders’ secret recipe for Kentucky Fried Chicken. The growth in same-store sales (the measure of growth favored by retail security analysts) has been relatively flat for KFC’s over 5,000 stores in the United States. The same is true for the Pizza Hut and Taco Bell chains. But the parent company of these fast food establishments, a company appropriately called Yum Brands, has enjoyed high double-digit profit growth from its operations in China. Yum Brands opens a new restaurant every 22 hours in China. KFC may be a laggard at home but it is doing a finger-lickin’ good business in China. KFC’s mascot “Chicky” is far more recognizable in China than “Ronald McDonald” of the rival chain. Yum Brands has also launched a new restaurant chain in China called “East Dawning.” The chain serves chicken prepared with traditional elements of Chinese cuisine and its restaurants are designed to resemble a comfortable Chinese home. Indeed, income from China is so significant that Yum Brands breaks it out as a separate item in its annual report.

A rapidly growing but aging middle-class population with money to spend should bring new demand for many U.S. drug and medical equipment companies, such as Pfizer and Johnson & Johnson. The propensity of the Chinese to save also should benefit asset managers. While China's asset management business is still in its infancy, AIG, Merrill Lynch, and Morgan Stanley have established footholds in China and have formed joint venture companies.

Macao, located 37 miles southwest of Hong Kong, has developed into the largest gaming and entertainment market in the world, now surpassing Las Vegas. Hundreds of millions of Chinese live in an area within a two-hour drive or two-hour airplane flight to Macao. Macao is not only a leading destination for mainland Chinese, who simply cross the border, but it has become a leading international destination resort. In 2004, Macao ended the 40-year monopoly over gambling casinos that had been given to Stanley Ho, known in China as "The King of Gamble." Now international companies can enter the market, and two U.S. companies, Las Vegas Sands and Wynn resorts, have become leading players.

Las Vegas Sands was the first U.S. entrant into the market. The Sands Macao opened in 2005 and the (Sands) Venetian Macao Resort opened in 2007 on a Las Vegas-style strip on reclaimed land called Cotai. Thanks to an insatiable demand for gambling by the Chinese, gambling revenues in Macao now exceed those in Las Vegas. Well over half of Las Vegas Sands resort revenues come from Macao.

Steve Wynn of Wynn resorts also likes Macao's odds – so much that he was spending two hours a day on Chinese lessons before Wynn Macao opened in September, 2006. Featuring 600 hotel rooms, 100,000 square feet of gambling space, 26,000 square

feet of retail space, and seven restaurants, the casino has been adding millions to the firm's bottom line. Wynn resorts current expansion plans include an addition to this highly successful mega-casino as well as a second casino-resort on the Cotai strip. For the flamboyant Steve, it was clearly a big Wynn in Macao. And the future looks even brighter, Wynn opines: "Macao is directly in the path of a huge avalanche of revenues."

Many other U.S. company household names are major players in the Chinese market. And they bring their marketing know how with them to make sure they stay major players. When Procter and Gamble, for example, found that low-income women in China only washed their hair once a week, it reformulated its China brand shampoo to keep hair cleaner longer. Goldman Sachs is a leading Asian investment banker. Starbucks projects that China (though it is a nation of tea drinkers) will become the company's largest market outside the United States. Honeywell's China revenues are almost 10 percent of the company's total, and they are growing at 20 percent per year. Motorola enjoys rapidly growing cell phone sales in China. A recent survey by the U.S.-China Business Council reported that profit margins for its members in China were as large or larger than those in any other part of the world.

One relative riskless way to profit from the growth of China, therefore, is to buy the shares of U.S. companies whose earnings stand to benefit from their China-related activities. Exhibit 10.10 presents a broad list of U.S. companies that have substantial interests in China. Exhibit 10.11 plots the returns from these three dozen U.S. companies with substantial China interests, compared with the Standard and Poor's 500 stock index.

Exhibit 10.10

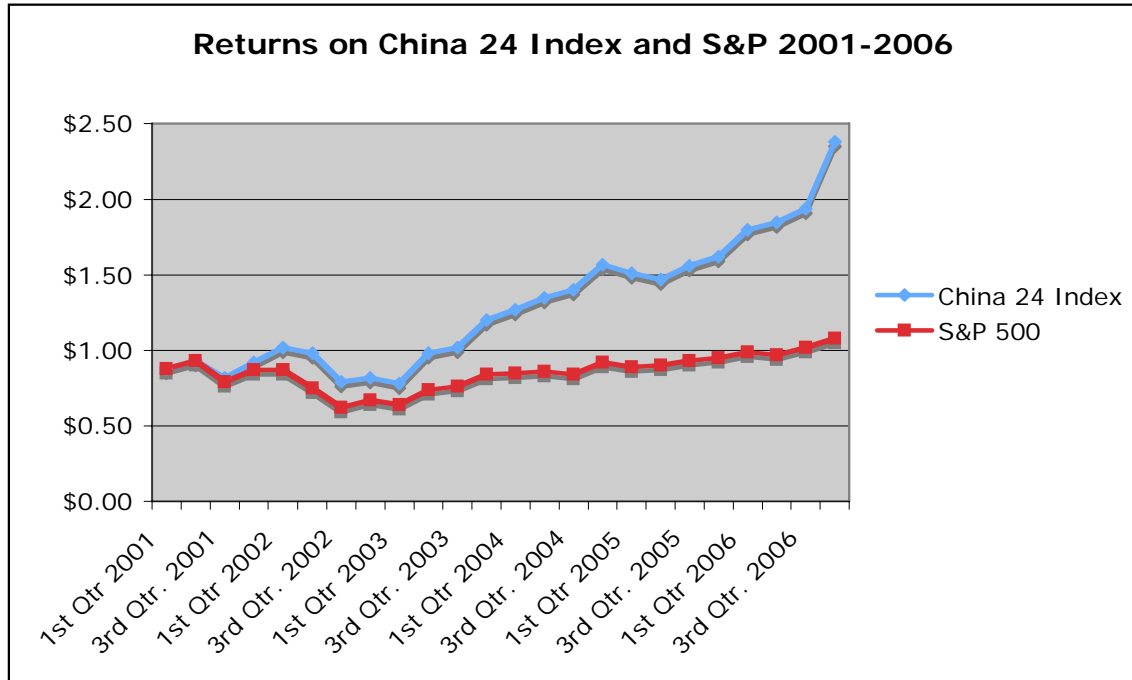
United States Companies with Significant Operations in China

Information Technology	Motorola, Honeywell, Microsoft, IBM, Cisco Systems, Oracle, Hewlett Packard, eBay
Finance	Citigroup, Bank of America, Goldman Sachs, Merrill Lynch, Morgan Stanley
Consumer	P&G, American Express
Pharmaceuticals	Johnson & Johnson, Pfizer
Retail	Wal-Mart
Industrials	Du-Pont, GE
Auto	General Motors, Ford
Food	Coca Cola, Pepsi, Yum Brands, Starbucks, McDonalds, Anheuser Busch
Entertainment	Wynn Resorts, Disney, Las Vegas Sands
Real Estate	ProLogis
Transportation	UPS, Fed Ex
Insurance	AIG
Materials	Phelps Dodge, Alcoa, Sherwin Williams

Exhibit 10.11

Performance of U.S. Companies* with Substantial China Interests vs. S&P 500

2001-2006



*The U.S. China Index is an equal weighted index assuming an investment in all the companies listed in Exhibit 10.10.

There are, however, two major problems with an offshore method utilizing a basket of U.S. companies profiting from their China dealings. First, it would be prohibitively expensive for individuals to buy and hold shares in such a large number of companies. Second, there are only extremely limited opportunities for buying funds that offer such a strategy. We are familiar with only one such fund, the Alger China U.S. Growth Fund (ticker symbol CHUSX), and even this is only a partial play. CHUSX is about evenly divided between U.S.-headquartered companies that receive significant profits from their China activities and major China companies that are traded on international exchanges. In addition, this fund carries a hefty load. We feel that U.S.

investors would be well served if they were able to buy either an index fund or an ETF consisting of major U.S. companies that have significant earnings from their participation in China's economic boom.

European Multinational Corporations Also Look to China For Growth

European multinational corporations, many listed as ADRs on U.S. Exchanges, also offer potentially attractive indirect ways by which investors can benefit from the growth of China. An excellent example is the French Corporation LVMH (Louis Vuitton, Moët, Hennessy). LVMH's sales in China are expanding rapidly in several of its product categories. The fastest growth has been enjoyed by the company's designer accessories brand, Louis Vuitton. LV opened its first shop on the mainland in Shanghai in 2004. By the end of 2006, LV had over two dozen outlets in China. Yves Carcelle, the head of the design house, identifies China as "the focus of the company's attention" and the area from which "exponential growth" is expected.

By 2006, China accounted for more than 50 percent of the LV brand's sales. The Paris-based Louis Vuitton sold more purses, shoes, and gloves in China (including Hong Kong) than it did in Europe, which accounted for only about one-quarter of its sales. The (London) Economist reports that Chinese customers for luxury goods constitute "the most rapidly expanding demographic in the Chinese economy." The Chinese nouveau-riche were described as a "huge group of status-conscious, increasingly wealthy people hungry for brands and fanatical about shopping." A sign at the entrance to the "Lemon Lake" housing development says much about the way rich Chinese are looking to spend: "North American Demeanor: Rich and Strong."

Other European brands have also been extremely successful in China. Armani, Gucci, Hermes, Prada, and Versace are expanding rapidly in China. Nokia, the world's largest vendor of cell phones, also enjoys the largest share of the handset market in China. As the western part of the nation develops, there is still considerably room for growth. During the first nine months of 2006, China added about 50 million new mobile-phone subscribers, more than the entire population of South Korea. And Nokia keeps selling new and familiar phones to current subscribers. Indeed, by 2012, Nokia estimates the replacement market will constitute 80 percent of total sales.

Unilever and Nestle have considerable sales in China as does Phillips. L'Oreal has been quite successful with its Maybelline line. Volkswagen was an early entrant into the Chinese auto market, and BMW is ramping up quickly. The Swiss electrical infrastructure company ABB is winning contracts hand over fist to upgrade China's power grid. Siemens, Novartis, and Heinekens are well known brand names. Similarly, many multinational financial corporations domiciled in Europe have substantial Chinese interests. Zurich-based UBS, Europe's biggest bank, has made it clear that China is pivotal to the bank's future growth and profit. In 2006, it had a paper profit of over \$1 billion from its China activities. Barclays Bank derives a significant share of its profits from China. HSBC, the huge international financial conglomerate, is headquartered in London. It got its start in 1865 when it opened as the Hong Kong and Shanghai Banking Corporation. Its financial roots are deep in China, and it is one of the leading foreign institutions developing a consumer financial market in the country. In 2005, for example it became the first foreign bank to provide local currency services in mainland China.

Investors in European securities have many indigenous companies by which they can indirectly tap into the growth of China.

Clearly, European investors also can tap indirectly into the growth of China. Here again, there are few or no opportunities to do so inexpensively. We feel that an index fund or ETF of European companies profiting from their China activities would be an extremely useful tool not only for European investors but also for American shareholders since many of the European companies are also traded as ADRs on U.S. exchanges. Perhaps a fund might want to create “the best of the best” – an index of both U.S. and European companies for whom business in China is a significant factor in their operations.

A Summing Up

Of course, indirect investments in United States, European, and other Asian companies to gain exposure to China’s growth are not pure plays. While these companies will enjoy rapidly growing opportunities in China and are lower risk investments, their China activities will account for only a small percentage of overall revenue. Moreover, U.S., European, and Japanese companies are subject to overall market movement in the United States, Europe, and Japan and thus offer fewer diversification benefits than more direct investment in companies that do most of their business in China. But for the white knuckle crowd, who see the potential growth of China but do not dare to stray from those local investments with which they are most comfortable, the indirect off-shore method has much to recommend it.

PT;12/01/06;4155
BGM;12/06/06
PT;12/08/06;4332
JP;12/29/06;4452
PT;01/11/07;4403
BGM; 01/24/07;4,555
BGM ; 1/30/07;4,548
BGM;2/09/07;4683
BGM;2/15/07;4691

Chapter 11

The Go for Broke Method

It is not the return on my investment that I am concerned about;
it is the return of my investment.

--Will Rogers

This is the chapter for gamblers, for those who like to play even when the odds are stacked against them. If they do win, however, the jackpots can be large. Here we will take you through the labyrinth of how to buy individual Chinese stocks as well as give you some idea of what areas financial gurus are placing their bets on as this book goes to press. First, however, in order to keep you out of too much trouble, we present a few basic stock-picking guidelines.

Three Stock-Picking Guidelines

Let it be noted at the outset that while these guidelines are valid for buying individual stocks on your own in large, efficiently functioning markets, they acquire special Chinese characteristics when applied to mainland China companies. These characteristics are described under each guideline.

#1. Buy stocks that are expected to have above-average earnings growth for at least five years.

Future earnings growth is the basic criterion for picking any stock. Throughout history, all the hugely successful company investments have been characterized by extraordinary growth in earnings per share. Let's say a stock is selling for \$15, earns \$1 per share, and thus has a price/earnings (P/E) multiple of 15 (about the long-run market average in the United States). The next year, the company's earnings increase by 15 percent, boosting the per share earnings to \$1.15. If the already low P/E remains constant, the stock will now sell for \$17.25. Of course, the market could get excited about the company's earnings growth and feel that it should have a higher P/E multiple. Let's say, the market feels the company's stellar earnings growth should be conservatively rewarded by assigning the company's stock price a P/E multiple of 18. Bingo! By multiplying the \$1.15 per share earnings by 18, you now have a share price of \$20.70 – an increase of 38 percent in just one year. Not bad.

Earnings per share of off-shore listed Chinese companies have been growing at rates well above an annual 15 percent increase for the past several years. The problem, of course, is what constitutes earnings for a Chinese company. As reviewed in Chapter 8, the earnings of state-owned enterprises (SOEs) are often subject to the whims and policies of the government. Furthermore, the books of privately owned companies can be murky, to say the least.

2. Buy stocks with P/Es that are low relative to their growth prospects.

If you buy a stock whose earnings are growing rapidly and whose P/E is at or below the overall market P/E, you may have found a deal. As discussed in Chapter 6, the financial world uses the term "PEG ratio" to describe the relationship of price to earnings

growth; this ratio is widely regarded as a handy tool for picking stocks -- the lower the ratio, the better. Alas, everyone is looking for this kind of stock and it is the rare individual who can spot it among the hundreds of other stock pickers. Again, with regard to China stocks, the P/E data can be suspect and the intervention of the government can drastically alter any widely accepted growth prospects. And there is another problem. When you're dealing with individual China stocks, the P/E data are sometimes not readily available and consensus estimates on earnings growth are frequently not accessible for individual investors.

3. Buy stocks with glamour stories.

Now here is where China stocks really shine. There is glamour everywhere, or so it seems. The country's economy is the fastest growing in the world, and stories abound about the growth of the consumer class and the eagerness of major firms throughout the world to cash in on it. The point to remember here is that all that glitters is not necessarily gold. As mentioned repeatedly throughout this book, the Chinese are just as clever as Americans during the hay-day of the dot.com boom in coming up with creative corporate names in order to entice buyers. Tiens Biotech Group (TMV on the American Stock Exchange), for example, has nothing to do with biotech; rather it sells nutritional supplements and personal products.

The bottom line, which we keep emphasizing over and over, is that even if you follow these eminently sensible and practical guidelines, you will find that picking and then buying individual stocks in emerging markets such as China is fraught with danger to your financial well-being. As *Motley Fool* contributor Will Frankenhoff has noted, purchasing Chinese stocks can be categorized as a manic-depressive activity.

The Elusive Ideal of the Ten Baggers

Glamour, growth – who can resist it? Peter Lynch, the famous investor and co-author of *One Up on Wall Street*, created the term “ten bagger” to describe the lucrative potential of such stocks. Borrowing from baseball slang, in which a single hit gets a runner to first base or the first bag, a “ten bagger” is the equivalent of two home runs and a double. For the stock buyer, it means that the value of her purchase has gone up ten

times or by 1000 percent. By one means or another, many Chinese stocks look like they are multiple “baggers” and some have been home runs. At least one, as shown in Exhibit 11.1, was actually a ten bagger.

Exhibit 11.1

Home-Run Stock Returns and More on Mainland China: 1999-2006

<u>Company</u>	<u>Sector</u>	<u>Total Return (%)</u>	<u>Annualized Return (%)</u>
Financial Street	Real Estate	1,411	49.6
Rocket	Machinery Equipment	848	39.6
Yunnan Baiyao	Pharmaceutical	715	36.5
Lake Chemical	Salt/Potash	634	34.4
OCT	Tourism/ Real Estate	518	31.0

SOURCE: Boseria Fund Management

Is there a catch to Exhibit 11.1? Sadly, yes. Only mainland Chinese or institutions with QFII quotas were able to buy these stocks as they are listed only on the Shanghai and Shenzhen stock exchanges. What about those not residing in China? U.S. residents have many options – not all of them easy – when it comes to buying Chinese shares that are listed on exchanges outside of mainland China.

A Primer on How to Buy Chinese Stocks Outside China

With regard to U.S. stock exchanges, Americans can buy Chinese companies in the form of ADRs (American Depositary Receipts) or ADSs (American Depositary Shares). They can also buy ADRs and ADSs on what is known as the “pink sheets.” And, finally, they can also – with some difficulty and often a great deal of expense -- buy shares directly on the Hong Kong Stock Exchange.

ADRs and ADSs on U.S. stock exchanges

As dollar-denominated, negotiable U.S. securities, ADRs provide the easiest way for U.S. investors to buy shares in foreign companies and thus obtain global portfolio diversification. First created in 1927, ADRs did not come into their own until the past quarter century or so, the time when globalization became rooted in the world economy. There are three levels of ADRs. Level I is regarded as the entry-level ADR, and these shares are generally traded as pink sheets, discussed below. Level I ADRs are not required to meet SEC disclosure policies. Level II and Level III ADRs must meet all SEC Securities Exchange Act requirements, which include the detailed filing of financial statements and corporate information. The major difference between the two is that ADRs at Level III, the most stringent of all, can raise capital via public offerings in the U.S.

Many familiar international firms trade on U.S. exchanges as ADRs; among these are Nokia and British Petroleum. Chinese ADRs on the New York and NASDAQ exchanges are either at Level II or Level III. As mentioned in Chapter 4, in order to make an ADR share price somewhat reasonable by American standards, the ADRs often represent bundled shares. Thus, one Sinopec ADR on the New York Stock Exchange is the equivalent of 100 Sinopec shares traded on the Shanghai Stock Exchange. ADRs and ADSs are often thought to be the same, and in one sense they are, in that the requirements for listing are the same. Technically, however, an ADS is an actual share that is being traded and an ADR consists of a bundle of ADSs. For example, the Shanghai Petroleum Company Ltd., the wholly owned subsidiary of Sinopec, trades as an ADS on the New York Stock Exchange, and one share on that exchange is the same as one share on the Shanghai Stock Exchange.

Pink Sheets

The term “pink sheets” is a holdover from the days when quotes for stocks listed here were actually printed on pink paper. Today, it’s an area that, in one sense, represents the underworld of stock trading in the U.S. It’s the place where bankrupt companies are banished; when Delphi – the motor parts company – went bankrupt, its stock was delisted on the New York Stock Exchange and sent to the pink sheets. It’s also a place where

companies who do not want to open their books prefer to list. Not all such companies are sleazy, fly-by-night operations – the giant Swiss firm, Nestle, is listed on the pink sheets. And it is also the place where several Chinese companies, particularly the property development companies, prefer to list.

Though pink sheets are known for being thinly traded – which means you could wait several days before finding a buyer for the 200 pink sheet shares that you want to sell – some of the companies, such as the Cheung Kong Holdings property development company, have an average daily trading volume of over 60,000 shares. This large volume is possible because in 1999, a limited liability company with the very appropriate name of Pink Sheets LLC introduced an electronic quotation service that displaced the old pink sheet system. Even with this service, however, it is extremely difficult to find relevant information on any pink sheet shares. Sometimes, because the shares are so thinly traded, you can only track down a quote that is several weeks old. For more active shares, you generally have to wait at least an hour after the market has closed to obtain information on your share's price. For those wishing to buy shares of foreign institutions that do not open their books to public scrutiny, pink sheets can provide a means – though frequently not an efficient one -- of buying such shares in dollar-denominated securities.

Hong Kong Stock Exchange

Many foreign institutions, such as the China-owned COSCO Pacific Ltd., forego the bother of listing on foreign exchanges. Staying on their host country's exchange is good enough for them. Thus, the only way individuals can buy the shares of many Chinese firms is to purchase them on the Hong Kong Stock Exchange. This is not as easy as it sounds.

Let's say, for example, that you wanted to buy 100 shares of COSCO Pacific Ltd. This is a Chinese container-related conglomerate and represents an interest in all the shipping into, out of, and within China. The U.S. accounting firm PricewaterhouseCoopers audits the books, and major U.S. firms, including Merrill Lynch, Goldman Sachs, Morgan Stanley, and Citigroup, track its performance. At the time this book went to press, shares in this company were only sold on the Hong Kong Stock Exchange.

We set out to find first hand how we could purchase shares in COSCO Pacific Ltd. We called several major, widely respected brokerage firms. Some frankly admitted they had no idea how to purchase Hong Kong stocks. Others said they would only do so with a minimum order of \$20,000. Still others said they would check with their international desks and try to get back to us within the week. The bottom line: Though it is not impossible to buy Hong Kong listed stocks, you will find that many U.S. brokerage firms are not prepared to quickly and efficiently handle individual, non-corporate requests for such transactions.

By default, then, most investors wishing to purchase Chinese stocks on their own rather than through mutual or exchange traded funds must do so on their home country stock exchanges. This severely limits the universe of available purchases. In the United States, for example, the number of domestic listed stocks goes well into the thousands. The number of Chinese companies that are listed on U.S. stock exchanges barely reaches the hundreds. And of those listed in the U.S., many are on the pink sheets and thus do not come under strict regulatory scrutiny and are often very thinly traded.

Chinese Sectors – and Stocks, Too -- Deemed Hot

Still, as mentioned at the beginning, this is a chapter for gamblers, for those who like to experience the manic-depressive instability of picking individual stocks. And there are many companies that appear exceedingly beguiling as far as investments in China go. As this book goes to press, stock analysts and financial gurus are touting stocks in the following areas as offering substantial future growth and presently moderate price-earnings multiples.

We want to make it perfectly clear that we do not recommend any of these stocks. Rather, we reiterate that they are among the favorites of financial firms as this book goes to press. These are hot stocks as we write but they could be stone cold as you read about them now. You might have fun comparing their performance from the time these words were written – February 2007 – to now, the time when you are reading these words. To track performance, simply go to yahoo.com, click on Finance, and then type in the stock symbol next to the Get Quotes area. Click on the Get Quotes box and you will be presented with information such as the dividend yield and P/E on the stock, as well as a

small chart tracking the daily volume and price fluctuation. You can click on the time periods under the chart to obtain a long-run price chart, and to be able to compare how well or how poorly the individual stock performed over the designated period versus other stocks or other benchmarks.

Consumer Companies.

The Y generation – those 20 and 30 somethings – is coming into its own in China. These young adults are major consumers and are heavily influenced by western culture. They like to spend and set the standard for those following in their footsteps. As a result, the level of savings is starting to flatten and consumption expenditures, spurred by this generation, are steadily rising. Credit Suisse predicts that by 2014 Chinese consumers could well replace American consumers as engines of global economic growth. The market potential within China for a broad array of consumer products is simply the largest in the world.

- COFCO INTERNATIONAL LTD. Operating in Hong Kong and throughout mainland China, this major food processing and trading company also engages in wine making and the distribution of chocolate products. It strikes a chord with Chinese consumers not only because of the quality of its products but also because it is a mainland company and not an outside one. While the basic story isn't glamorous, its earnings and overall growth have been excellent. Listed on: Hong Kong Stock Exchange (0506.hk); four German exchanges – Berlin (CFH.BE), Frankfurt (CFH.F), Munich (CFH.MU), and Stuttgart (CFH.SG); and U.S. pink sheets (CFITF.PK).
- MENGNIU DAIRY. “Look at the management rather than the financial reports,” one Chinese mutual fund manager told us, and both he and major U.S. brokerage firms highly praise Mengniu President Niu Gensheng. Under Niu's leadership, this privately held company has become one of the leading dairy product manufacturers in China. In 2001, the government started a program requiring all pupils to drink a cup of milk

daily; Mengniu's Flying Cow brand is now a staple in schools throughout the country. Clever marketing – building on national pride -- has also propelled earnings for this company: China's astronauts drank its milk, U.S. basketball star Yao Ming is a spokesman, and Olympic medalists also back it. With the government's increased emphasis on health and education, Mengniu is expected to prosper – especially with the development of the western part of the country. Listed on: Hong Kong Stock Exchange (2319.HK); three German exchanges – Berlin (EZQ.BE), Munich (EZQ.MU), and Stuttgart (EZQ.SG); and U.S. pink sheets (CIADF.PK).

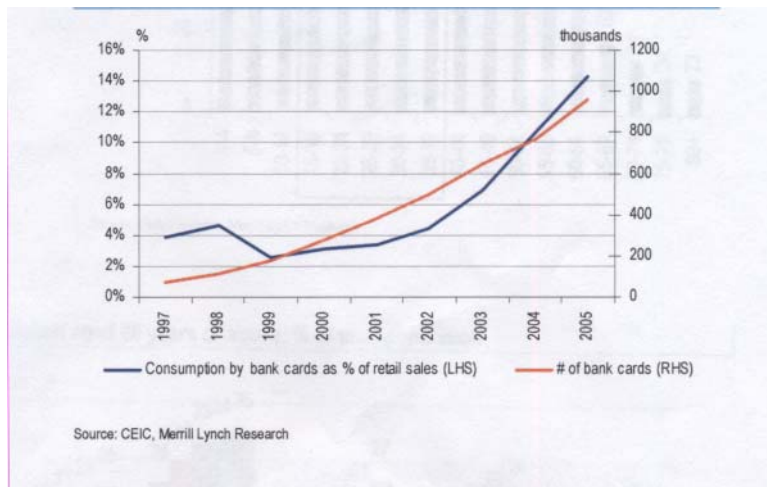
- MINDRAY MEDICAL INTERNATIONAL LTD. Established in 1991, Mindray Medical is an example of the growing marketing and technical sophistication of Chinese companies. With offices in 29 major cities throughout China and in the U.S., U.K., Canada, Turkey, and Hong Kong as well, it develops, manufactures, and markets medical devices across three business segments -- patient monitors, clinical laboratory instruments, and ultrasound imaging systems. Listed on: New York Stock Exchange (MR).
- LI NING COMPANY LTD. One of the leading sporting goods enterprises in mainland China, Li Ning Company designs, brands, manufactures, and retails sports footwear, apparel, and accessories. It is expected to benefit not only from increasing consumer purchases in the coastal areas but also from the economic growth forecast for the western part of the country. Listed on: Hong Kong Stock Exchange (2331.HK); three German exchanges – Berlin (LNL.BE), Frankfurt (LNL.F), and Munich (LNL.MU); and U.S. pink sheets (LNNGF.PK).

Financial Firms

Bank SOEs have undergone massive cleanups in recent years. All major financial institutions are buying in – Morgan Stanley, Goldman Sachs, Bank of America, Citicorp, Barclays Bank, etc. The big international banks are buying into the China banks because

of the huge potential for banking services throughout the vast country. As shown in Exhibit 11.2, credit card ownership, in just one example, is now starting to catch on and the fees on the cards can be extremely lucrative. Unfortunately, Chinese financial shares can not be considered unrecognized. They sell at a considerably higher P/E ratio than do the U.S. major international banks and insurance companies.

Exhibit 11.2
Growing Use of Bank Cards in China



- **CHINA MERCHANTS BANK.** Under the astute leadership of President Ma Weihua, CMB had a successful Initial Public Offering in fall 2006 and continues to wrack up impressive results, particularly in the area of corporate governance. The first and only large commercial bank not owned directly by the Chinese government, CMB is a major domestic credit card issuer and is known for its high asset quality. Listed on: Shanghai Stock Exchange (600036.ss); Hong Kong Stock Exchange (3968.HK); and U.S. pink sheets (CIHHF.PK and CIHKF.PK).
- **CHINA INSURANCE.** Operating out of mainland China, Hong Kong, and the British Virgin Islands, China Insurance is a major underwriter of reinsurance. It is also active in issuing direct life insurance and in property investments. Listed on: Hong Kong Stock Exchange (966.hk).

- PING AN INSURANCE. Another hydra-headed Chinese firm with, as its name implies, major involvements in the insurance industry, the company also owns a major and lucrative stake in the all-service commercial and retail Shanghai Pudong Development Bank, which is only listed on the Shanghai Stock Exchange (600000.SS). Listed on: Hong Kong Stock Exchange (2318.HK) and U.S. pink sheets (PIAIF.PK).

Infrastructure Corporations

As Merrill Lynch declared in a report on China trends to 2010, the biggest infrastructure boom in history is in the making. In a five-year program covering the years 2006-2010, the government is committed to spending \$480 billion to upgrade the country's transportation infrastructure. Of that over \$150 billion will be invested in railways. Deutsche Bank analysts have called the Chinese railway industry a "must own." In addition to transportation expenditures, billions of dollars will also be spent on upgrading water supply and waste water treatment and in infrastructure-related projects in rural areas. Two companies that are widely expected to benefit from the infrastructure boom are Daqin Railway and China Railway Tielong Container Logistics; unfortunately, for those outside China, these are only listed on local exchanges. The following, however, are listed outside mainland China.

- ANHUI EXPRESSWAY CO. LTD. The company should benefit from the government's major investments in both the western region of the country and transportation infrastructure. Anhui Expressway owns and develops toll roads in China's (central) Anhui Province. State entities hold controlling interest in the company. And, because this is after all a Chinese company and is therefore Byzantine in its structure, Anhui Expressway also owns a majority stake in Kangcheng Pharmaceutical, a research and development firm. Listed on: Hong Kong Stock Exchange (995.HK) and U.S. pink sheets (AUHAF.PK and AUHEF.PK).
- SINOTRANS LTD. A majority-controlled subsidiary of the government-owned China National Foreign Trade Transportation Group, Sinotrans has

an almost ironclad guarantee to participate in the government's infrastructure investments. As one of China's leading logistics companies, it will do so through providing air, ocean, road, and rail freight forwarding as well as through warehousing services. Its international partners include UPS and DHL. Listed on: Hong Kong Stock Exchange (0598.HK); four German exchanges – Berlin (SIY.BE), Frankfurt (SIY.F), Munich (SIY.MU), and Stuttgart (SIY.SG); and U.S. pink sheets (SNOTF.PK).

- GUANSHEN RAILWAY. A way to participate in both increased leisure travel within mainland China as well as the government's investment in infrastructure, Guangshan Railway Company operates the only railroad between Guangzhou and Shenzhen and as such is the principal provider of passenger and freight transportation services in this lucrative and booming area near Hong Kong. Listed on: Hong Kong Stock Exchange (525.HK); Frankfurt Stock Exchange (GRC.F); and New York Stock Exchange (GSH).

Energy Related Companies

At the same time that China is gobbling up energy in its efforts to give its people a comfortable living, it is also a world leader in promoting energy efficiency. In the government's latest five-year program, announced in 2006, the country is committed to cutting energy consumption by unit of GDP by 20 percent. In addition, energy conservation is now officially an important performance assessment factor for local governments.

- CHINA PETROLEUM AND CHEMICAL CORP. (ALSO KNOWN AS SINOPEC). Described in detail in Chapter 8, this petrochemical refining and production is an SOE under the close supervision of the government. Nevertheless, it should benefit under the current programs to encourage both production and conservation of energy. Listed on: Hong Kong Stock Exchange (0386.HK); New York Stock Exchange (SNP); and Shanghai Stock Exchange (800028.SS).

- SUNTECH POWER HOLDINGS. Established in 2001 by the then-38-year-old Dr. Zhengrong Shi, Suntech Power is one of the world's largest solar cell manufacturers and is continuing to expand and grow. In 2006, it set up a wholly owned subsidiary in the U.S. and tapped into the rapidly growing U.S. solar market. Given the Chinese government's commitment to energy conservation, it has enormous potential in its home country. Suntech's initial public offering was in the United States and it fully complies with all SEC requirements. Listed on: New York Stock Exchange (STP).
- CHINA NATIONAL OFFSHORE OIL CORPORATION (ALSO KNOWN AS CNOOC). The third-largest national oil company in China and approximately 70 percent state owned, CNOOC focuses on the exploitation, exploration, and development of offshore crude oil and natural gas. Under the leadership of its urbane chairman Fu Chengyu, CNOOC has aggressively acquired numerous stakes in international oil fields. Listed on: Hong Kong Stock Exchange (0883.HK) and the New York Stock Exchange (CEO).

Leisure Activities

According to United Nations projections, there will be over 400 million mainland Chinese between the ages of 20 and 39 by 2015. This group, almost the size of the entire population of the European Union, likes to spend and have fun. They enjoy – some might say are addicted to -- the perks and pleasures of instant communications, and they are also starting to engage in vacation travel, particularly throughout their own vast country. This is the age group that will fuel the growth of non-business activities.

- NETEASE.COM. Named *The Motley Fool's* best international stock for 2007, NetEase serves millions of Chinese gamers with its extremely popular MMORPGs (massively multiplayer online role playing game), free email, news stories, blogs, and more. With over 500 million daily page views, NetEase is one of China's most visited websites. Its advertising revenue is growing, its PEG ratio, as this book goes to press, is

low, and its operating and net margins are enviable and surpass those of Yahoo. NetEase.com is also a classic example of why U.S. investors may want to stick to companies listed on their own exchanges. In 2001, NASDAQ was prepared to delist the stock because of financial reporting irregularities. William Ding, founder of the company, publicly apologized, promptly submitted a new statement, and declared, “We will try to prove that we are honest in handling the false reporting affair.”

Listed on: four German exchanges – Berlin (NEH.BE), Frankfurt (NEH.F), Munich (NEH.MU), and Stuttgart (NEH.SG); and U.S. NASDAQ (NTES).

- FOCUS MEDIA. As described in detail in Chapter 2, this company captures leisure time rather than leisure activity by presenting advertising to captive audiences in elevators, hotel lobbies, train stations, etc. As this book goes to Press, Focus Media has a very high P/E multiple but a moderate PEG ratio. Listed on: three German exchanges – Berlin (F10.BE), Frankfurt (F10.F), and Munich (F10.MU); and U.S. NASDAQ (FMCN).

The Company that Struck Out

We have presented some exciting examples of Chinese companies that have enjoyed superior growth in the past and that, in the eyes of many professionals, offer excellent prospects for future growth. But in the extraordinarily volatile Chinese market, there have been many flame outs as well. Investors who try to buy undervalued stocks should do so only if they have a cast iron stomach for risk.

Perhaps one of the most incredible rags to riches to rags stories is that of a Chinese company that started out in 1997 as a construction company with the name OLS Group Ltd. Two years later it acquired a sexier moniker when it changed its name to China Prosperity Holdings and as such managed to get a NASDAQ listing with a ticker symbol of CPIH. The construction business was not going that well, however, so the company decided it would do better to get into the internet business. It did so by announcing that it had acquired the exclusive rights to develop broadband internet and cable television networks in Sichuan Province.

Talk about a ten bagger! The stock went from 1 to 36 just like that and, in June 2000, the company became known as Prosper eVision Ltd. There was a slight problem, however. The company did not, it turned out, have exclusive internet rights in Sichuan. The SEC stepped in, the stock was delisted, and the name changed to a rather anonymous China Nan Feng Group Ltd. As this book goes to press, it has changed its name once again to a catchy Green Energy Group Ltd. It is, however, back where it started from and trades as a “penny stock.”

And Then There’s the Company that Never Even Got to First Base

In 1992, amid much fanfare, Brilliance China Automotive became the first Chinese company to list (ticket symbol CBA) on the New York Stock Exchange. As shown in Exhibit 11.3, the stock has essentially gone nowhere. Indeed, when inflation is factored in, original investors have lost buckets.

Exhibit 11.3

China Brilliance Automotive: 1992-2007



Source: <http://finance.yahoo.com>.

In the time period of the listing, the stock was suspended briefly for financial irregularities, the founder and chief executive officer Yang Rong was forced out, and the local Liaoning government bought a controlling interest at a purported 93 percent

discount to the market price. Yes indeed, buying Chinese stocks can be a manic-depressive activity.

A Summing Up

Buying individual Chinese stocks is difficult to do because so few are listed on exchanges outside of mainland China and Hong Kong. And possessing shares in Chinese companies can be fraught with financial peril because of the convoluted structure and ownership of these companies. Buying individual Chinese stocks is not what we suggest you do with your retirement money. Still, there are opportunities, and those who have money they can afford to lose might wish to take the slight chance of reaping huge rewards by investing in individual Chinese companies. The odds may be better than playing the lottery. For all other readers of this book, we believe you should not buy individual Chinese shares. Instead, we recommend what we regard as The Optimal Method in the following chapter.

BGM, 12/07/2006; 6,435
PT, 12/14/2006;
BGM;1/30/2007;3196
BGM/PT;2/09/07;3157
BGM;2/15/07;2159

Chapter 12

The Optimal Investment Strategy

“He who would walk sanely amid the opposing
perils in the path of life always need a little
optimism; he also needs a little pessimism.”

--Havelock Ellis

It is our thesis that large rewards can be earned by investors who position themselves to benefit from the growth of China. China has grown from a poor underdeveloped nation to one that has become a world economic powerhouse. Already China is the world's second largest economy on the basis of purchasing power. We believe that even if China's growth trajectory slows, as it undoubtedly will, China will become the largest economy in the world by 2020. China has always had a dynamic and energetic population, one -- with exception of the Mao years -- with a culture of entrepreneurship and commerce. Now that the Chinese dragon has awakened from the ravages of the cultural revolution, China is an integral part of the world economy as an important producer and exporter of goods and as a major consumer of raw materials.

China is also becoming a nation of individual consumers who can increasingly afford the goods and services that consumers around the world already have.

It is also our thesis that investment in China can be very scary and involves considerable risk. As described in chapters throughout this book, corruption is rampant, corporate financial statements can be murky and misleading, and the heavy presence of the government's hand is not always in the shareholder's interest. While progress has been made in combating these problems, major risks remain. Moreover, the Chinese stock market -- including the Chinese stocks that trade in Hong Kong and in the United States markets -- is the poster example of volatility and gives new meaning to the phrase "China's wild ride." The mainland China stock market fell 50 percent from 2001 through 2005 and then rose over 100 percent during 2006. It is also important to remember that if you lose 50 percent in one period and gain 100 percent in the next you have not made a positive return -- you have only broken even. Small wonder that less bullish investment advice sometimes appears with titles such as "The Best China Investment Strategy: Forget About It." Despite all the risks, however, the opportunities are so large that we believe all investors should have some exposure to China's growth. But you should do so by employing a strategy that reduces risk as much as possible.

Four General Rules to Minimize the Risk of Investing in China

What follows are four general rules that will allow investors to pursue an "Investment in China's Growth Strategy" with as small a risk as possible.

1. Diversify Broadly

We do not recommend that nonprofessional investors attempt to purchase individual stocks. Accurate information is extremely hard to come by and some individual issues have lost almost their entire value during certain past periods. Moreover, there are many complications and additional fees involved for United States investors in purchasing any individual shares that are not listed on the New York Stock Exchange or the NASDAQ market. Investors need broad diversification to contain risk and expense. In effect, this means that ordinary investors will need to purchase funds rather than individual issues. The funds may be mutual funds, closed-end funds, or exchange traded funds. Below we will give specific advice.

2. Invest in Chinese Securities Gradually over Time

We believe that money should be committed to Chinese funds gradually over time – not all at once. We recommend that an initial investment be no more than one quarter of the total funds you plan to commit to Chinese securities. The remainder should be invested in periodic intervals as much as a year apart. Why such a cautious approach? Because by not investing all at once the investor lessens the risk of putting all his money in the market at a speculative peak. The technique of investing gradually over time is called “dollar cost averaging” by market professionals. It is a particularly useful strategy in as volatile a market as China. The investor will not put all of her money to work at a market low but she will also avoid the regret of plunging in at a peak.

3. Be Aware of Costs – Lower Investment Cost Means Higher Returns For You.

Investment costs play a crucial role in determining your net investment return. There's no evidence that buying a fund that charges high costs will lead to higher net returns. In the investment world you don't get what you pay for. Quite the opposite is true. You get what you don't pay for. So buy funds with low management fees. Never buy a fund with a load fee (sales charge) attached. Exchange traded funds have particularly low management fees. But when you buy them do so through a discount broker. Do not pay more than \$10 per trade. Every fee or charge that you can keep to a minimum means a higher net return to you.

4. Employ a Mixed Strategy of Both Direct and Indirect Investments

Risk can further be reduced by employing a mixed strategy. There are many indirect ways of investing to benefit from China's growth. We discussed in Chapter 10 a large number of investments in China's trading partners or in commodity producers who benefit from China's growth (as they will from the growth of India, which is enjoying the world's second highest growth rate). Because these investments are domiciled in countries where transparency is greater and fraud is less likely to exist, investment risk is substantially reduced.

The Optimal Mixed Strategy

We recommend a mixed strategy as the optimal method for profiting from China's enormous economic growth and rise to power. This strategy combines direct investments in Chinese companies with the indirect methods to benefit from China's growth. These indirect methods include investing in companies domiciled in other countries that benefit from China through trade or direct investment or because they manufacture their goods there. Such companies are likely to have fewer governance and corruption issues and represent lower risk investment alternatives. In addition, investments in raw materials and the companies that produce them will continue to benefit from the growth of China as well as India and other rapidly developing countries.

The Mixed Strategy: Some General Guidelines

We believe that moneys devoted to a China strategy will bear far less risk if the following seven guidelines are employed:

1. Only half the moneys devoted to China should be invested directly in Chinese securities. The other half should be placed in stocks of non-Chinese companies that will benefit from the growth of China and in commodities, especially in commodity producers.
2. Of the moneys invested in Chinese securities, broad diversification is essential. Investors with limited means should not buy individual Chinese stocks but rather should focus on managed open- or closed-end funds or ETFs. Buyers of just one or two Chinese stocks should consider such purchases as speculation.

3. If ETFs are used, we recommend diversification among three ETFs. As described in Chapter 9, these are: FXI (a fund containing 25 Hong Kong listed stocks, EWH (another fund of Hong Kong stocks with a heavy proportion of property companies, providing the investor with real estate exposure), and PGJ (a fund containing stocks of Chinese companies traded in New York).
4. If actively managed funds are to be used, we suggest the following priorities:
 - a) If closed-end funds are available at substantial discounts, closed-end funds are preferred to open-end funds. We believe closed-end funds are attractive only if they sell at discounts of 10 percent or more.
 - b) If open-end funds are used, choose funds with relatively low expense ratios and low turnover. Never buy a fund with a sales charge.
5. The remaining 50 percent of the funds devoted to a China strategy should be invested in commodity investments and in the stocks of countries that are closely tied to China through trade and investment.
6. Commodities and their producers can easily be accessed through mutual funds and/or ETFs and we recommend this approach rather than buying individual companies. As described in Chapter 10, we believe all portfolios should have some exposure to commodities and their producers.
7. Investors with substantial assets should buy stocks of companies domiciled in China's main trading partners that will obtain a meaningful share of their future growth from China-related activities. (See Chapter 10). Alternatively, country ETFs may be purchased representing China's major trading partners. Investors without enough resources to buy several different instruments would

gain some benefits from the growth of China (and India) by purchasing an emerging-market index fund or ETF.

Comments on the Mixed Strategy

We believe that approximately half of the moneys devoted to a China investment strategy should be placed in funds that have direct investments in Chinese companies.

The other half should be devoted to indirect exposure to China.

Direct Investments in Chinese Stocks

Strategies for direct investment in Chinese equities will depend upon whether investors are Chinese citizens or foreigners or whether the foreign investors have a QFII quota. As noted above, the A-share markets are not yet efficient; thus, active management rather than passive indexing strategies are recommended for those who can access the A-share market. In Chapter 8, we listed some managed open-end funds that we favored for investment. But as this book goes to press, we prefer managed closed-end funds available at substantial discounts. Equities are available through closed-end funds at discounts of about 25 percent. Particularly since the funds have maturity dates in the future when they will liquidate, investors in closed-end funds will earn returns that exceed those available from the market as a whole. A sample of mainland closed-end funds that we favor is contained in Chapter 9.

For foreign investors who do not have QFII quotas, as well as investors who can buy A shares but who wish to diversify into the H- and N-share markets, we believe that either managed or index funds are viable solutions. We showed that the H and N share markets tended to have somewhat more profitable stocks and that these markets were more efficient than the A-

share markets. The names of the U.S. domiciled China mutual funds and the closed-end funds we favor are also contained in Chapter 9.

If the closed-end shares are available at substantial discounts, we favor those shares. Closed-end funds are easier to manage than open-end funds. The open-end fund manager is often forced to buy at market peaks and sell at market troughs due to the fickle whims of the investing public. (Public investors invariably tend to put money into mutual funds at market peaks when enthusiasm is widespread and to liquidate their holdings during market troughs.) Closed-end fund managers have more control over the timing of their purchases and sales. When investors liquidate their closed-end shares, the closed-end manager is not required to liquidate portfolio holdings. This aspect is advantageous when dealing with Chinese shares because the transactions costs of buying and selling are quite large. When these funds are available at discounts, it is time to open your wallets to closed-end funds.

Indexing is also a useful strategy in the H and N markets. These markets are open to international institutional investors and tend to be more efficient than the A-share markets. They also tend to have relatively low expense ratios. Three such funds are traded on U.S. exchanges. The FTSE/Xinhua Index of 25 of the major Hong Kong listed Chinese shares is traded under the ticker symbol of FXI. An ETF of approximately 50 N shares is called the Golden Dragon Halter PowerShares and trades under the ticker symbol PGJ. A third ETF we favor is the MSCI-Hong Kong Index Fund. It contains a group of Hong Kong companies that derive most of their profits from China and it trades under the ticker symbol EWH. EWH has a heavy weighting of real estate companies. As mentioned in Chapter 7, exposure to Chinese property development companies can be risky; such risk is considerably lessened, however, with the diversification

benefits provided by EWH.

Indirect Methods of Investing in China

Why has the price of oil and other commodities risen sharply during the early 2000s? Why has Japan begun to recover from its long stagnation that started in 1990? We believe a major reason is the growth of China. And China has provided the labor force and manufacturing facilities for the Taiwanese computer chip industry and for many Hong Kong companies. Investments in commodities and their producers and in companies domiciled in Japan, Taiwan, Hong Kong, and China's other trading partners represent an indirect method to benefit from the growth of China. And we showed in Chapter 10, many U.S. companies have also derived an important share of their growth from China-related activities.

We believe that diversifying the Chinese portion of a portfolio with as much as half dedicated to indirect investments provides an excellent risk/reward balance. Such a diversified portfolio will be far less volatile than a portfolio restricted to direct Chinese investments. A mixed portfolio including indirect investments is likely to produce generous returns even if China's growth falls short of the optimistic forecasts we hold.

Investing half the funds devoted to a China strategy in commodities and companies domiciled outside of China will substantially reduce risk. The indirect investments in non-Chinese companies will ensure that a substantial share of the investments is subject to better corporate governance. Suppose India grows faster than China? The indirect investments will also gain from India's growth as well as the growth in other developing countries of the world. Investing in China should not be restricted to investing only in companies domiciled on the Chinese mainland.

Some Practical Portfolio Strategies for U.S. Investors

Investors with substantial resources can use the general guidelines outlined above and the detailed recommendations from earlier chapters to implement the mixed (lower risk) China strategy we recommend. But that strategy envisions the use of many different instruments. Exposure must be obtained not only to the stocks of companies operating in China but also to commodity companies and to the stocks of companies in other countries that benefit from China's growth. If active strategies are employed, such as buying portfolios of stocks in Japan, Taiwan, and the United States that derive substantial benefits from China, large numbers of individual investments must be made. Investors with limited resources will not find such a strategy to be feasible and even investors with slightly more resources will find it far too expensive. What strategies can we recommend for investors with limited resources who want to place at least some of their funds in investments that will benefit from the awakening of the sleeping Chinese Dragon?

The simplest strategy is to make one investment in a diversified fund that invests in the stocks of Chinese companies available to international investors. The fund might be active or passive. Some recommended actively managed open- and closed-end funds were listed in Chapter 9. If closed-end funds are available at substantial (for example, double digit) discounts, we favor the closed-end funds. One of the three China ETFs would also be acceptable as a one-stop shopping vehicle to obtain exposure to China.

A slightly more complicated strategy that would be low expense and well diversified as well as containing elements of the mixed strategy we favor is presented in Exhibit 12.1. Here a well diversified set of indexed equity investments is proposed for a U.S. investor.

Exhibit 12.1

A Simple All Indexed Equity Strategy for U.S. Investors

	Direct
China Fund	50%
iShares FTSE/Xinhua (FXI)	
or PowerShares Golden Dragon (PGJ)	
or iShares MSCI Hing Kong (EWH)	
or closed-end managed Fund if available as a discount	
	Indirect
Emerging Markets Trading Partners	40%
Vanguard MSCI Em-Mkt Viper (VWO)	
Commodity Fund	10%
CRB Commodity Index ETF (DBC)	
or Vanguard Energy Viper (VDE) and Vanguard Materials Viper (VAW)	

Investors with sufficient resources to diversify the China-Emerging Market portion of the portfolio more broadly could consider the all-ETF portfolio shown in Exhibit 12.2.

Exhibit 12.2

An All-ETF Portfolio to Exploit the Growth of China

ETF	Ticker	Expense Ratio	Proposed weighting	
iShares FTSE/Xinhua China	FXI	0.74	25.0%	China and Hong Kong 60%
PowerShares Golden Dragon	PGJ	0.60	17.5%	
Halter USX China				
iShares MSCI Hong Kong	EWH	0.59	17.5%	
iShares MSCI South Korea	EWY	0.74	7.0%	China-linked 40%
iShares MSCI Japan	EWJ	0.59	7.0%	
iShares MSCI Taiwan	EWT	0.74	5.0%	
iShares MSCI Singapore	EWS	0.59	5.0%	
iShares MSCI Malaysia	EWM	0.59	3.0%	
iShares MSCI Australia	EWA	0.59	3.0%	
Vanguard Energy VIPERs	VDE	0.26	4.0%	
StreetTracks Gold Shares	GLD	0.40	3.0%	
Vanguard Materials VIPER	VAW	0.25	3.0%	

Blended expense ratio: 0.62% based on a 100% ETF portfolio

*Source: Active Investment Advisors: A Division of IXIS**

**Dr. Malkiel chairs the Investment Committee of Active Investment Advisors.*

Sixty percent of the portfolio is invested in China-company shares traded in Hong Kong or New York. Some of the companies in the three ETFs are actually domiciled in Hong Kong rather than on the mainland. Hence we increased the weight of this portion of the portfolio from 50 to 60 percent. The other forty percent is invested in China's major trading partners, not including the United States. Ten percent of the portfolio is invested in commodities, including gold, which is a favorite savings vehicle for the Chinese people. This ETF portfolio has tended to produce generous returns with only moderate volatility.

The careful reader will notice that almost no mention has been made of two very promising strategies covered in Chapter 10. We refer first to the strategy of buying a portfolio of Japanese companies that greatly benefit either from trade with China or from offshoring their manufacturing to low-wage China. The second strategy was to invest in a subset of U.S. domiciled companies that benefit substantially from their association with China. We showed that portfolios of such companies have handily outdistanced the market averages in Japan and in the United States.

Investors with substantial resources can (and should) adopt such strategies. But as yet no funds are available to permit a small investor to access such portfolios. We hope that such funds are developed soon. They would be a welcome addition to the portfolio choices available for international investors.

A Summing Up

The transformation of China is the economic miracle story of the 21st century. The pace of growth is so rapid that each month China builds a new city equivalent to the size of Houston. China is now central to world commerce. Even if its growth rate slows, China will be the largest economy in the world by 2020, when size is measured in terms of purchasing power.

The Beijing Olympics in 2008 and the Shanghai World Expo in 2010 will focus the eyes of the world on China. No well diversified investment portfolio can afford to ignore the potentially profitable investments that China offers.