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❖ Horizon Asset Management, Inc. ❖

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Interim Market Commentary

*China – The Problem of Slowing Growth?*

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In assessing the historic collapse of financial asset prices in the U.S. this past year, one might attribute it to a constellation of structural pressures and risks that had been building for some time. These would include a low national savings rate, high personal debt balances, over-leveraged banks, a structural trade deficit, growing balance of payments deficit, rising national budget deficit, and so forth. America is still, though, the world's reserve currency. The Chinese stock market decline was worse. And why not; it is not America, after all, is it?

No, it isn't. China has a high savings rate, its banks are well capitalized, it generates a trade surplus (indeed the U.S. trade deficit is, essentially, its deficit with China), and it has the world's largest foreign reserve balance and a budget surplus. China's virtues are, indeed, the virtual inverse of the flaws of the U.S. In this sense, China is a hedge against the structural risks of U.S. based investments, apart from its pure investment potential, and this, clearly, is not well appreciated.

Certainly, it is appreciated that China is the 3<sup>rd</sup>, if not the 2<sup>nd</sup>, largest economy in the world, depending on the metric used. It is appreciated that it is about the only meaningfully expanding major economy in the world (irrespective of other economic figures, it appears to be a fact that 5% more automobiles were sold in China in March of this year than in March of last year). It is probably not appreciated that its \$586 billion stimulus package, on a proportional GDP basis, dwarfs the \$700 billion U.S. plan. If the U.S. wished to engage in a proportionately equal stimulus package, keeping in mind our GDP is over 3x that of China's, we would have to spend over \$2 trillion. Moreover, whereas the U.S. stimulus package is debt-funded, China's might well be funded by the next few of years' of fiscal surplus.

Nevertheless, the valuations of many of China's major publicly traded companies, which have superior balance sheets, greater growth rates, fewer regulatory and competitive impediments to growth, and virtually no legal tort risk and expense relative to U.S. companies, have traded at lower valuations, even below (as in the case of essential, monopoly-type businesses such as electric utilities, airports and highways) construction cost or book value. Perhaps this is an expression of a Western world view of China as an exotic investment. It is not, though, the product of objective reasoning.

The change in China is historic, and it is emerging in a manner that has not occurred before. Its 1.3 billion people represent over 20% of the world population; changes in that nation cannot be ignored. The country's university system produces over 4 million graduates per year, a figure that is not so different than in the U.S., but which has been expanding at double-digit annual percentage rates. Its *urban* population now exceeds 600 million, or twice the total U.S. population, and is expanding rapidly. The conversion of an agrarian society to a highly literate one is the structural framework for creating a modern economy. In the course of one generation, China is creating the technology infrastructure, consumer economy and financial system that required the U.S. several generations to achieve. Contemplate the extraordinary value creation that occurred in the U.S. during the

50 years after World War II, the wealth one could have accumulated by purchasing a handful of shares of any one of the major consumer products or other disposable income growth beneficiaries of that era, such as a Procter & Gamble or Merck or IBM.

One may consider that environment to be in the process of reenactment in China today. One small example is a Chinese mutual fund company known as Value Partners. There is only a small number of sizable investment firms in China; these will be natural repositories of the incremental savings of the population, which is expanding, in multiplicative fashion, not only in total numbers, but also in urban numbers and in per capita income and in disposable income. The sheer magnitude of savings that will be generated in the ensuing decade will be large, indeed. Moreover, this investment company incorporates an additional multiplicative factor, in the form of operating leverage. Unlike U.S. mutual funds, Chinese mutual funds charge a performance fee in addition to the management fee, much like U.S. hedge funds. One can envision the possibilities.

The same can be said for China Life Insurance Company, which has a 40% market share, and which experienced a 20% increase in policy fees and net premiums written in 2008. Not that a 40% market share would be possible within the U.S. regulatory framework, but can one imagine the possibilities of owning such a life insurer in the U.S. 50 years ago. The actual market shares of the largest five U.S. life insurers do not aggregate to China Life's market share; for interest, they are: 16% (American International Group), 8% (Metropolitan Life), 5% (Northwestern Mutual), 4% (Prudential), and 4% (New York Life).

The absolute and relative virtues don't end here. When one purchases a company that conducts its business in the Chinese currency, one thereby owns a Renminbi earnings stream. Aside from the divergent fiscal realities and policies of the U.S. and China, from which logic would dictate a weakening dollar, various purchasing power exercises will suggest that the Chinese currency is massively undervalued relative to the U.S. dollar. During the past two years, one would have earned 6.6% (2008) and 7.0% just via this modality. If one considers that to be a base return level, then the achievement of a double digit return requires only the most modest contribution from inflation and/or unit growth and/or margin expansion, much less valuation expansion. The achievement of prodigious double-digit growth is easily attained if any of these additional factors is more than modest, or if a few of them, albeit modestly, operate together.

There is also an entirely additional dimension to the ownership of Chinese company shares. It is not unique, since it is also shared by India, but almost so. All of the 21 constituents of the MSCI EAFE index of global standard stock market indices, meant to represent the economies of the world in rough order of their GDP contributions, have a greater weight than China. These include, in addition to major economies such as Japan and Germany, the less-than-colossal Ireland, Greece, Portugal and Belgium, which do not even sum to three-quarters of California's Gross State Product. This must be so, though, since China, perhaps surprisingly, has a zero weight. Yet, the MSCI EAFE index is the

benchmark that institutional investment managers use to determine their portfolio allocations, and against which they are measured. There must come a day when the producers of this global benchmark determine a method by which to include China, one that somehow reconciles both its appropriately major GDP weight with its exceedingly modest free-float stock market capitalization. On that day, irrespective of their viewpoints, global fund managers will be forced to purchase shares of Chinese companies or, through proxies such as ETFs, try to accomplish the same. The results will be interesting.

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