Hong Kong 2018

Greg Debski, CFA
Portfolio Manager

The world is a very different place when analyzed in person, versus through the headlines and pages of a Bloomberg Terminal. A recent journey to Hong Kong yet again brought this fact to the forefront and serves as a great reminder of why we don't just say "we go the distance for our clients", we actually go.

The purpose of this trip was two-fold, the first being the 71st CFA Institute Annual Conference. The 4-day event was an opportunity to meet with and hear from a broad slate of professionals with a direct focus on, or investment exposure to, the region. The second objective of course was research. Research meetings with several current and potential portfolio holdings in the area provided an in-person checkup on the state of affairs within the firms, along with a local "temperature check" on the macro happenings in Hong Kong, China, and the broader ASEAN (Association of Southeast Asian Nations) region. Since this time around "going the distance" meant over 18,000 miles in the air, the pressure was on to maximize time spent on the far side of the globe.

The CFA Institute Conference delivered in spades on its reputation for aggregating an impressive collection of speakers and topics. Presenters ranged from preeminent academics to global asset management heavy-hitters, and included the likes of Nobel Laureate Daniel Kahneman, Steve Eisman (of *The Big Short* fame), and Hiro Mizuno (CIO of the $1.4 Trillion USD Japanese Government Pension Fund). Topics varied from the trendy (cryptocurrencies, A.I., and blockchain) to the obscure (Chinese distressed debt investing, telecommunications infrastructure in Nigeria, and robot ethics), while also touching on the shifting landscape of performance measurement, the developing opportunities in Asian emerging markets, and the CFA Institute's ongoing crusade for a more ethical industry championed by the fiduciary commitments of CFA charterholders.

China, with its 1.4 billion people, was credited repeatedly with being on the cusp of economic super-power status. The inside jokes of 15 years ago (China is great at the B2B and C2C economies: Bring 2 Beijing and Copy 2 China!) are long gone, and have been replaced by expectations for Chinese GDP surpassing that of the United States by 2025. Since 2010, per capita GDP has more than doubled, with expectations for doubling again by 2025. The impacts of this vast increase in wealth on consumption are visible everywhere. New car sales per year in China are rapidly approaching 29 million units, far above the 17 million annual number in the U.S., representing an impressive 34% of total global demand. Of the 465 million mobile phones sold globally last quarter, 143 million were sold by Chinese companies, with 5 of the 10 largest mobile handset builders in the world based in China. And just like in the U.S., where younger parts of the population are flocking to cities for high-tech and service-oriented jobs, the migration of young well-educated workers in China to cities has resulted in 4 of the 10 largest cities in the world being located in the country. Incredibly, it only takes 15 of China's largest cities to nearly surpass the entire population of the United States. However, despite the eye-popping demographic statistics, risks do continue to lurk in the shadows. Credit ratings issued by Chinese banks, along with the financial statements of state-backed companies in the region, continue to be viewed as suspect, despite having improved by leaps and bounds in transparency. Pollution, a constrained supply of health care services, and social unrest all hover over everyone's mind. And while no one wants to admit that a trade war is a threat, the fact is that a trade war is at least a pressing concern. Suffice to say, while opportunity abounds to a casual observer, focused due diligence and a buyer-beware outlook remain a prudent tact in the region for an active participant.

Hong Kong, with its status as a Special Administrative Region of China, operates in a rather peculiar position, both as China's currency exchange conduit with the outside world, and as something of a western-influenced appetizer before embarking on the entrée of Mainland China. Turned over from Great Britain in 1997 and operating under an autonomous governing agreement until about 2040, Hong Kong manages to operate as an eclectic mix of China and Britain. Close to $12 Billion USD is spent on infrastructure in the region annually, clearly visible in the elaborate web of subterranean and surface level roads, rail lines, overpasses, and walkways. Space is so valuable that nearly every inch that is not covered by a road or sidewalk is occupied by a sky scraper. Residential property is notoriously the most expensive in the world, and car parking spots routinely sell for hundreds of thousands of U.S. dollars. The concrete jungle is punctuated with the occasional park or athletic field, which is a pleasant reprieve from the intensity of the city.

The efficient movement of people and things is a critical economic precursor, and Hong Kong is certainly not unique in its intensity towards infrastructure investment. In fact, the majority of firms visited while in the area provided unique insight into the infrastructure development happening in Hong Kong, Mainland China, and the broader region. The first visit was with an old-line infrastructure conglomerate with over 40 years of experience in the region, operating everything from toll roads, bus lines, and highway tunnels, to an airplane leasing company and a portfolio of waste treatment facilities. Their properties span the ASEAN region, with the bulk operating in Mainland China. The firm is looking to tackle the shortage of healthcare services in China by opening a chain of facilities similar to walk-in clinics here in the U.S. Given their vast portfolio of retail properties, they have embedded cost advantages in doing so. When asked how an infrastructure company can benefit from the growth of technology in the region, the answer was an enthusiastic "easy, just look at Hangzhou!" Hangzhou is the headquarter city of Alibaba, and guess who happens to own the toll roads surrounding the city…?

Another meeting was with the firm that owns and operates the subway and rail lines in and around Hong Kong. Regardless of having a monopoly in subway transit (which despite being inundated with travelers is clean and incredibly efficient), the bulk of the company's earnings come from the retail space in its subway stations, along with high-rise property development around those stations. In recent years, the company has brought its business model to the world stage, and has developed operations in Australia, Sweden, and the UK in addition to their expanding assets in Hong Kong and Mainland China.

Infrastructure investments such as these have many appealing characteristics, both as an asset owner and as an investor. As a result, these types of companies are a key component in most client portfolios. Dividend yields are often higher than other types of investments due to the high and consistently reliable nature of cash flows from the underlying businesses. Additionally, the investments offer a reduced correlation with the rest of a portfolio due to the focus on the movement of goods and people, instead of the creation and sales of products or services. Conviction in the theme was pleasantly validated by China in 2016 with the announcement of "The Belt and Road Initiative". This multi-trillion-dollar undertaking has the potential to reshape the movement of goods across the entire Eurasian region, and many of the firms we follow in the region are excited about potential development opportunities.

The most memorable parts of the trip all stem from the vastness of it all; the vast amount of people, buildings, cities, commerce, and opportunity. The vast time frame and reach of every proposed plan and idea was also astonishing. The CIO of Japan's $1.4 Trillion USD GPIF made the point that focusing on anything less than <u>3 years</u> is counterproductive, or even destructive, to the long-term success of a business or investment. And while quarterly, monthly, or even daily monitoring of investment or business performance is undoubtedly more entertaining, a multi-year outlook is an idea that needs constant revisiting. We strive to maintain a multi-year investment outlook for the companies we invest in, with status updates continually in the interim. Solid execution and expanding opportunity are met with increased conviction and investment, while a persistent failure of either is met with an eventual exit. The region looks to have expanding opportunities for years to come, both in infrastructure investments and others. Should solid execution follow suit, look for more companies from the region to enter our ranks.