Strategist's Corner
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Growing Chinese Regulatory Burden a Way of Life

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Equity markets around the world carry with them certain risks. In the United States, heady valuations and the threat to margins resulting from ESG — where higher input costs could, for example, erode earnings — are risks. In Europe, it's the highly cyclical nature of much of that market that poses risks. But I want to focus on China, where in my view government regulatory risk is a hazard with which investors must contend.

In recent weeks, a number of industries have come under increasing government scrutiny, sending tremors through equity markets. Cybersecurity has become a major focus. Not only does Beijing want to keep consumers' data secure from hackers, it wants for its own ends unfettered access to the data companies collect. The government also wants to ensure that data collected in China by firms with overseas stock listings don't end up in the hands of foreign regulators.

Firms that offer food delivery have found themselves in the crosshairs as well. The government is pushing them to raise the pay of their drivers, provide them with insurance and ease their delivery deadlines.

Companies that offer after-school tutoring have also attracted unwanted government attention. President Xi Jinping has been particularly critical of the industry, and the government recently banned for-profit education firms in an effort to drive down the cost of schooling and make child-rearing more affordable. China's rapidly aging demographic profile has prompted the government to recently lift limits on family size, among other measures, to encourage population growth.

Video game makers are the latest to feel the government's sting, with state media recently calling online gaming "opium for the mind." But in fact, the industry has been under increasing regulation for much of the past decade. And a growing regulatory burden, as it does in most countries, tends to favor well-established incumbents at the expense of startups, which possess more meager resources.

For most of these companies, more regulation is just the cost of doing business. Entrenched market leaders manage to pass along higher labor costs and the like without a materially negative impact on their enterprise values. The tutoring companies, however, must deal with an entirely new business model.

Notwithstanding the recent flurry of headlines, China has always been a heavily regulated market. Regulations are adopted, evolve and are sometimes repealed, and they touch every sector. They're one more factor that needs to be evaluated as part of our fundamental research process. As such, Chinese stocks have fatter tail risks than most global equities, and Chinese Internet stocks are riskier still, with wide ranges of possible outcomes. But the risks must be balanced against China's massive total addressable market and consequently shouldn't be ignored. It's important to identify companies led by skilled operators who can manage within government strictures. To us, that's the sweet spot. But given the Chinese market's wider-than-average range of outcomes, judicious risk management, such as appropriately sizing positions in portfolios, is essential.

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