THE PRUDENT PALADIN

THE PALADIN GROUP AT MORGAN STANLEY

THE HARDEST HUE TO HOLD

3rd Quarter, 2021

American dominance? Chinese resurgence? Both? Neither? While many current events are interesting, frankly our group wanted to take a departure from some of our usual comments about Washington being unable to get much done, overvaluation, and why even the most educated people in the world fail miserably at economic predictions.

So, if you were looking for more of that, you can go ahead and close out this newsletter and re-read some of the older ones! This time around, we would like to discuss China, and while we may not have all of the answers, we feel this is an important topic to dive into more deeply.

In addition to speaking about China, we must also look in the mirror, as China represents the only nation with the possibility of exceeding the USA's economic might, and some would argue they have already achieved this goal. Because it is possible that our best days are behind us and it is possible that China's best days are also in the past, we selected a poem by the famous Robert Frost this quarter. While not his most famous work, the imagery is beautiful and emblematic of our theme for this quarter.

> "NATURE'S FIRST GREEN IS GOLD,
> HER HARDEST HUE TO HOLD.
> HER EARLY LEAF'S A FLOWER;
> BUT ONLY SO AN HOUR.
> THEN LEAF SUBSIDES TO LEAF.
> SO EDEN SANK TO GRIEF,
> SO DAWN GOES DOWN TO DAY.
> NOTHING GOLD CAN STAY." –
> ROBERT FROST

As much as the human race tends to repeat the same issues throughout history, we must also realize the fact that this may be temporary. Our lives, our bliss, our pain, all of it. This also ties into the economy and investment markets. Investors can have hindsight bias to some degree, in other words we tend to believe that something that has recently occurred will continue to recur indefinitely, despite the incessant warnings of "past performance does not guarantee future results."

At the individual investment level, this makes sense. We can easily remember technologies and companies that have come and gone, and the research backs this up, with the average life expectancy of an S&P 500 company being only 21 years![i]

However, at the societal or country level, this is more difficult to conceptualize, because even our most senior clients were only young adults in the 1950's, and the USA was still the dominant world economy at the time. Put simply, the majority of Americans today have never known anything other than the USA being the dominant global power player. Specifically, the USA has had the largest GDP in the world since at least 1890, according to British economics firm Angus Maddison.[ii]

However, until 1890 China held the top ranking (leaving aside the combined might of the British Empire and India, then the British Raj). It is no secret that Xi Jinping, much like his predecessors Mao Zedong and Deng Xiaoping, wants to see his homeland take back its place at the top of the global rankings.

This goal took a great leap forward (pun intended) in the shadows of the financial crisis. Specifically, China has accounted for over 65% of the growth in the global economy from 2011-2020[iii]. It is because of this growth that China has gotten significantly more attention in recent years.

Perhaps the most interesting part of China's growth has been their rejection of democracy, free-market capitalism, property rights, and the type of financial transparency we enjoy in the USA. Frankly, it is sensible to believe that any other economic system would lead to despair, famine, and economic decline. The examples of systems other than capitalism failing are plentiful, including the communist Soviet Union, Cuba under Fidel Castro, and more. It is understandable to be concerned when Xi Jinping states that he believes Marxist/Leninist/Maoist thought is what got China to where it is[iv], rather than Deng Xiaoping's embrace of some parts of Western democracy and capitalism.

All of that said, we are investors and advisors, not politicians, policymakers, nor diplomats. We cannot shape the world in which we have to invest, we must invest within the world we have, and not allow our personal political beliefs to cloud our judgment about investment opportunities.

To this end, China presents an interesting conundrum. China's growth has been obvious, and investors with exposure to the Chinese market have been rewarded from time to time in the past 10 years. But at what cost? First, let us open up the topic that is corporate governance for Chinese publicly traded companies.

In the USA, common stockholders have the right to vote, transfer ownership, receive dividends, sue for wrongful acts, inspect corporate documents, and in the event of a liquidation, receive compensation after creditors, debtholders, and preferred stockholders have been paid. Additionally, they have direct ownership of the company in which they are purchasing shares. [v]

In China, this is not so. At present, there is no way for foreign investors to directly own stock in a Chinese company. So, how is it possible to invest in China? The answer lies in a structure that seems more like a Rube Goldberg machine than anything else. It works something like this: USA-based investor wants to invest in China, the Chinese company forms a shell company in some other jurisdiction such as the Cayman Islands, the shell company collects capital from USA-based investor, the shell company and the Chinese company enter into a contractual agreement to swap investor capital for operating results, and now foreign investors can buy stock in the shell company.[vi] Sound confusing? You bet!

So far, this arrangement has been to the benefit, not the detriment of investor capital, due to the Chinese government making good on their contractual agreements. As a result, both non-Chinese and Chinese investors have seen compelling growth in their investments, with the MSCI China index's 5-year return of 16.6% nearly matching the S&P 500's return of 17.7% over that same period.[vii]

However, we would be lying if we said that this type of arrangement gives us great comfort. At the same time, looking back into the mirror, to insinuate that some of the best companies in the USA have completely fair ownership structures would also be dishonest. To be more specific, two out of the four companies that make up the famous "FANG" stocks (Facebook, Amazon, Netflix, and Google) do not offer equal voting rights between the founders of the company and the average investor. [viii]

This means that if you buy a share in one of these companies, you may have zero voting rights; or, at best, you could have 10 times less the voting power of the founder. In other words, the founders of some companies can raise capital through the public markets (very capitalistic) while still maintaining effectively total control. However, much like Chinese technology stocks, the performance of the FANG cohort has been compelling enough that many investors (ourselves included) are willing to look past these corporate governance issues, at least for now.

Circling back to our theme for this quarter, can the USA or China hold their golden hues? In the case of China, the luster appears to be wearing off, with the CSI Overseas China Internet Index (an index tracking China based companies whose primary business or businesses are focused on internet and internet-related technology) being down 37.5% over the past 6 months as of September 30.[ix] Perhaps the Chinese internet sector's best days are in the rearview mirror, but it is also possible that all of the potential bad news we just mentioned is now reflected in the price, and profits, not peril, are what is to come.

And what about the USA? Are our best days behind us as well? Perhaps it is our patriotism, but our answer is no. Despite our belief that investors ought to maintain exposure to stocks globally, we do not think the USA is on death's doorstep, even if current sentiment feels that way.

More specifically, September is historically the worst month for stocks with US stocks on average losing 0.7% in that month (time period 1926-2021)[x]. Perhaps that, combined with the Delta variant, is what is driving consumer confidence lower, and some pundits are suggesting that this is an omen of bad things to come, whereas we are not so certain.

To be sure, a correction in the stock market is a normal part of every market cycle, whether it is a paltry 5% loss or something as big as a 20% fall, our longer-term optimism is unwavering, and we feel history is on our side.

On consumer confidence, interesting enough, it appears that those data readings could be a contra indicator of future returns, meaning that if consumers feel badly about the economy and the stock market (as the data indicate today[xi]), then that could be a good time to buy, or that when the reading is too high, this could be a good time to take some profits[xii].

Additionally, let us not forget the power of momentum. 2021 is one of the top 20 best starts to the year for the US stock market, and on average, the returns from September through year-end are 4.5% to close out the year[xiii]. In other words, the trend could be your friend and we could have more gains to come.

In closing, we are aware we do not have a good answer to the China question, but we feel that no one really does, so we hope you excuse us. When you combine the governmental issues with the simple fact that every major US corporation has ties to the regime, the possibility of an investment posture that is completely "ex-China" is probably unattainable, so we feel our job is to monitor the situation, conduct proper due diligence on our emerging markets fund managers, and focus on the pillars of investing success that have worked globally, like valuation, thinking like a contrarian, maintaining diversification, and patience.

Like the "average" September in the stock market, performance was not great this time around, with the S&P 500 falling 4.7% during the month to finish up 15.9% for the year. In keeping with our theme, China fared far worse, with the MSCI China Index falling 18.1% for the quarter, making it down 16.6% for the year. While bonds have also had a rough year, they have not fallen enough to give investors compelling interest rates, with the 10-year US Treasury note sitting at a yield of 1.49%, up from the 0.92% it possessed at the beginning of 2021.

Finally, despite all of the talk of inflation, there have not been many places to hide outside of the stock market and the oil market. The Bloomberg precious metals index is down 10% for the year, Gold is down 7.4% for the year, and US TIPS (treasury inflation protected securities) are up only 3.5% versus inflation, which was most recently 5.4%.[xiv]

Vann Russell
Financial Advisor
919 785 7166

Robert Randolph
Financial Advisor
919 785 7167

Bill Nave, CFP®
Financial Advisor
919 986 9570

Virginia Whitley
Financial Advisor
919 785 7163

3737 Glenwood Ave
Suite 320
Raleigh NC 27612

855 830 0665 toll free
919 881 8325 fax
advisor.morganstanley.com/the-paladin-group

[i] Source: Statista.com
[ii] Source: Data table in Maddison A (2007), Contours of the World Economy I-2030AD, Oxford University Press, ISBN 978-0199227204
[iii] Source: NYU & World Bank
[iv] Source: https://palladiummag.com/2019/05/31/xi-jinping-in-translation-chinas-guiding-ideology/
[v] Source: Investopedia https://www.investopedia.com/investing/know-your-shareholder-rights/
[vi] Source: NYU http://aswathdamodaran.blogspot.com/2021/09/chinas-tech-crackdown-market-adjustment.html
[vii] Source: iShares, as of June 30th 2021
[viii] Source: company filings, Vox media
[ix] Source: KraneShares.com
[x] Source: Blackrock, student of the market Sept 2021
[xi] Source: Conference Board September consumer confidence survey
[xii] Source: Journal of Portfolio Management Fall 2003, 30 (1) 115-127
[xiii] Source: Blackrock, student of the market Sept 2021
[xiv] Capital markets data from Morgan Stanley Capital Markets, inflation data from Bureau of Labor Statistics

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