

How to Hitch on to a Rising Star

While it can be an elusive target for investors, there are ways to increase your exposure to the world's fastest-growing major economy, ROB CARRICK writes

by ROB CARRICK

To astute investors, the sound of China rising is the ka-ching of money being made.

China's investing potential is such that some experts believe it's a must-have for your portfolio. As University of Toronto finance professor Eric Kirzner puts it: "A decent-sized portfolio without any exposure to China, and India, is deficient."

Now for the frustrating part. While China is the world's fastest-growing major economy, it's an elusive target for investors.

The problem is that China's stock market isn't as developed as its economy. There are as many as six different categories of publicly traded stocks, each with different rules on whether Chinese nationals or foreigners can buy them and which exchanges they trade on.

Investing in China is so exotic that there are only a small number of China-focused mutual funds available to Canadians, and few of them are ideal for getting true exposure to the country. A good alternative is a new exchange-traded fund that offers true exposure to China, but even here you'll encounter the idiosyncrasies of the Chinese market.

China's stock market at the end of 2003 was the eighth largest in the world, according to figures from money manager State Street Global Advisors. But the investable market -- the stocks in China, Hong Kong and Taiwan available to foreign investors -- is just 1.5 per cent of the global total.

So-called A shares are the ones that are off limits to all foreigners except qualified institutional investors. They've traded on the Shenzhen and Shanghai stock exchanges and priced in the local currency, called yuan. B shares are available to foreign investors -- they're traded on the same two exchanges, but quoted in Hong Kong dollars in Shenzhen and U.S. dollars in Shanghai.

Other stock categories include H shares, which are traded in Hong Kong and open to any investor, and Red Chips, which are unrestricted Hong

Kong-listed companies controlled by the Chinese government.

The mix of government share ownership and restrictions on foreign investment explain why some money managers are leery of directly investing in China even through they believe the country's incredible economic growth will be a dominant investing theme.

"China, in my view, is the big strategy issue for the next 10 to 20 years," said Wilf Hahn, president of Hahn Investment Stewards & Co. and a onetime head of Royal Bank of Canada's global investing operations. "But I think it's really tough for the individual investor to get some decent leverage on China."

Mr. Hahn said one option is to look at sectors and companies in established markets that either do business in China or benefit from commodity prices that have been propped up by demand from Chinese industry. Sectors profiting from China include oil and gas and metals, while examples of individual companies active in China are Sino-Forest Corp., a forestry company with operations in Southern China, Ivanhoe Energy Inc., an oil and gas company with projects in China, and insurer Manulife Financial Corp.

An easy choice for investing in Chinese companies is the growing category of China-focused mutual funds. The Globefund.com database shows seven funds with "China" in their name, but only two of them have a track record of as long as three years.

The newest of these funds is Bank of Montreal's BMO Greater China Class, which began trading a week or so ago. It's the first China fund from a bank family, and a reflection of both BMO's long-standing interest in the area and the recognition of a market that can't be ignored.

"Here's a market that is the fastest-growing economy in the world and in the next decade will be probably the second-largest economy in the world,"

said Ed Legzdins, president of BMO Investments. "The ability to invest in an economy that is growing at this rate is unique."

China-focused funds have certainly offered stellar returns recently, although this year's results are down somewhat and the long-term numbers vary. AGF China Focus Class, which dates back to April, 1994, made 63 per cent last year and has a return since inception of 2.87 per cent. Talvest China Plus made 40.5 per cent last year and a stunning 203.5 per cent gain in 1999, while the return since its inception in 1998 is 14.2 per cent.

The problem in buying funds like these is that they're not a pure play on China, says Prof. Kirzner, who teaches at the Rotman School of Management. Because of the difficulty in buying shares of Chinese companies, fund managers will often use companies listed in Hong Kong and Taiwan as proxies.

Check out Talvest China Plus -- 69 per cent of its assets were invested in Hong Kong as of June 30, with 27 per cent in Taiwan and the rest elsewhere. AGF China Focus was 95 per cent invested in Hong Kong as of Sept. 30. Some China funds go even further afield thanks to mandates that allow them to hold shares of global companies that do substantial business in China.

Fund analyst Dave Paterson of Paterson & Associates says most China funds are too new to properly assess. Of the two senior citizens, AGF and Talvest, he prefers the AGF fund. "This fund has produced better historical returns, with lower volatility," Mr. Paterson said.

Many China watchers in the investing world are excited about the new iShares FTSE/Xinhua China 25 Index Fund, which began trading this month on the New York Stock Exchange under the symbol FXI. This exchange-traded fund focuses directly on China by holding 25 of its largest, most liquid corporations.

Energy stocks account for almost 20 per cent of the Red Chips and H shares

Continued on other side→

in the fund, followed by telecom, industrials and financials. For more information, visit the iShares website at <http://www.ishares.com>.

Like any other ETF, the China 25 fund is bought like a stock through a brokerage account of any sort. The dividend yield on the fund is a respectable 2.67 per cent and the management expense ratio is 0.74 per cent, a true bargain compared with the 3.5-per-cent MER of AGF China Focus and the 3.2 per cent of Talvest China Plus.

The China 25 fund is priced in U.S. dollars, which means Canadian investors would see their profits eroded if our currency continues to appreciate against the U.S. dollar. Still, experts like Mr. Hahn see it as a top choice right now for investing in China.

Another option for investing in China is a sort of mutual fund-ETF blend called a closed-end fund. Think of this as an actively managed mutual fund that you buy like a stock, rather than through a fund company.

There are several closed-end funds listed on the NYSE that focus to varying extents on China, all with the common trait of trading at either a discount or premium to their net asset value. These funds trade at a premium when they're in vogue and at a discount when they're not. Experienced investors only buy at a discount.

Some NYSE-listed closed-end funds that offer China exposure are the Templeton Dragon Fund (TDF), the China Fund (CHN), the Greater China Fund (GCH), the JF China Region Fund (JFC) and the Taiwan Great China Fund (TFC). For more information on these funds, visit the Closed-End Fund Center website at <http://www.cefa.com>.

It's possible to buy the shares of Chinese companies directly through the Hong Kong exchange or on the NYSE and other U.S. markets. Roughly 45 Chinese companies trade in the United States as American depositary receipts (ADRs), which are essentially versions of an underlying stock denominated in U.S. dollars. Among the Chinese ADRs available is PetroChina, which Warren Buffett has a stake in.

The experience of China mutual funds suggests that there will be huge years and terrible years. Last year's bonanza

has been followed in 2004 by year-to-date losses in the range of 2 to 12 per cent. AGF China Focus, the oldest China fund, has posted five losing years in the past eight, including 2004.

This sort of volatility suggests that it's best to hold only a small portion of your portfolio in China, say 5 per cent for most people and 10 per cent for true believers. If you do buy a China-focused investment, make sure you're not doubling up on exposure you already have through an emerging market or Far East mutual fund.

China's economy has been growing at such a rate that there have been concerns it will overheat and topple over into recession. The Chinese government has been working to engineer the proverbial soft landing, but risks remain.

Given this uncertainty amid all the celebration of China's economic achievement, is this country truly a must-have in your portfolio?

"Absolutely," Prof. Kirzner said. "I've been saying that for years."

Investing in China

Here are some options for profiting from the spectacular growth of the Chinese economy:

iShares FTSE/Xinhua China 25 Index Fund (FXI-NYSE)

Description: An exchange-traded fund listed on the New York Stock Exchange that tracks the FTSE/Xinhua China 25-stock index, which comprises some of the largest, most liquid Chinese companies.

How to buy: Through any broker - commissions can be as little as \$25 (U.S.) at an on-line broker and you can buy any quantity you like.

Cost to own: The management expense ratio is 0.74 per cent.

Returns: The fund is new, but the index has a one-year return of 29 per cent and an annualized five-year return of 11.5 per cent (to Sept. 30).

Risk level: Very high

Alternatives: There are ETFs tracking the Hong Kong and Taiwan markets listed on the American Stock Exchange.

AGF China Focus Class and Talvest China Plus funds

Description: These mutual funds have the longest track record among China-focused specialty funds. They mainly hold shares of Chinese companies listed in Hong Kong and Taiwan.

How to buy: Through financial advisers or on-line brokers. Commissions may apply.

Cost to own: The MER on the AGF fund is 3.5 per cent, while the Talvest fund's MER is 3.2 per cent.

Returns: AGF has a one-year return of 17.6 per cent and a five-year compound average annual return of 11 per cent; Talvest China Plus made 8 per cent in the past year and 7.6 per cent in the past five years.

Risk level: Very high.

Alternatives: Several other fund companies have new China funds, including Bank of Montreal, Dynamic, Excel, Manulife and Templeton.

Mackenzie Universal Canadian Resource Fund

Description: A consistently strong resource fund with an emphasis on oil and gas stocks.

How to buy: Through financial adviser and on-line brokers. Commissions may apply.

Cost to own: The MER is 2.55 per cent. Returns: One-year return is 37 per cent; five-year annual return is 19.2 per cent.

Risk level: High.

Alternatives: There are roughly 60 natural resource funds available.

China Fund (CHN-NYSE)

Description: A closed-end fund that trades on the NYSE.

How to buy: Through any broker - commissions can be as little as \$25 (U.S.) at an on-line broker and you can buy any quantity you like.

Cost to own: The MER is about 1.5 per cent.

Returns: One-year loss is 7.8 per cent; five-year cumulative return is 21.4 per cent.

Risk level: Very high - this fund trades at a hefty premium to its net asset value right now.

Alternatives: There are at least four other closed-end China-focused funds listed on the NYSE.

SOURCE: THOMSON DATASTREAM