CUBIC ASSET MANAGEMENT, LLC

2011 4th Quarter Stock Market Commentary

SINOS PROBLEMS

"All I ask is a chance to prove that
money can't make me happy."
- Spike Milligan

As a small boy growing up in Brooklyn, I remember being told that if I dug a hole deep enough, I would end up in China. This was always puzzling. After all, since the world was round, and I knew that I was standing right side up, that would seem to imply that the Chinese people were hanging upside down, probably attached to the Earth by a precursor of Velcro. Of course, I know better now, but some practices in China still seem upside-down to me. Consider, for example, the peculiar ritual that takes place in China in late December. At a widely attended news conference the president of China announces the GDP growth rate for the year which is not yet concluded. The press corps publishes the figure, and business leaders around the world plan their capital spending for the coming year based upon a figure which has almost no chance of being correct. Contrast that with the United States, which has unquestionably the most accurate economic statistics of any country in the world. The Bureau of Labor Statistics, which releases an estimate roughly one month after year-end, revises that figure a month later, and then issues a final revision yet one more month after that.

As is usual, China reported a real growth rate hovering near 9%, as it has been every year since 1992. This is three times the long term growth rate of the rest of the world. Not surprisingly, this phenomenal growth rate has attracted the lion's share of foreign direct investment and has greatly enhanced China's geopolitical influence. There is no way to check the validity of this data, but it is worth noting that summing up the various sector-by-sector growth rates results in a much lower rate. Further, during the period 1992-2006, China's total energy consumption actually declined, despite the fact that the government reported that gross domestic product more than tripled.

China's National Bureau of Statistics routinely reports nearly full employment at high wages which are rising annually at a low double digit rate. But according to a survey taken by China Daily, which is Beijing's English language newspaper, fully 91% of respondents do not believe the official data, a sharp increase from 79% only four years ago. Goldman Sachs has developed a rating system for the reliability of Chinese government statistics which was published in the Economist. On a 1-5 scale, with 5 being the most reliable, statistics related to wages and employment were rated as 1, presumably because the Chinese Communist Party does not want to publish any data which might cause people to become disillusioned with the Party's economic policies.

Regional statistics are also suspect. Data for regional GDP growth are published annually by each of China's 31 provinces. Summing up the individual growth rates last year resulted in an aggregate figure 10% higher than the rate reported by the central government. Similar to Lake Wobegon, where every child is above average, 77% of the provinces reported growth last year in excess of the national average. In 1998, 97% of the provinces did so. Presumably, this increases local officials' chances for promotion.

It is not only governmental statistics that are questionable. Individual Chinese companies have been engaging in some unusually creative accounting. Probably the most prominent example is Sino-Forest (the prefix "Sino" refers to China), the Chinese timber company accused last June of fraud by stock research firm Muddy Waters, who claimed the company had overstated its timber assets. After vigorously refuting the allegations, Sino-Forest defaulted on two sets of bond payments in December after failing to publish financial results in a timely manner.

Probably the largest category of offenders are so-called "reverse merger" companies. Banks in China tend to favor state-owned companies when making loans, so privately owned companies generally have to tap the Western markets to raise capital. The easiest way to do this is to merge with an already publicly traded shell company (called a reverse merger), thus avoiding the bulk of regulatory requirements that come with filing for an initial public offering. Such companies typically have a U.S. based auditor, which in turn is subject to a review every three years by the PCAOB (Public Company Accounting Oversight Board). Last year, the SEC requested that the auditors verify the financial data of the companies they were auditing. More than two dozen auditors of Chinese reverse merger companies resigned, in most cases alleging fraud. One typical case involved Longtop Financial Technologies, which was audited by Deloitte Touche Tohmatsu. When Deloitte tried to verify cash holdings they were directed to a phony bank web site that Longtop had created to mimic an actual bank site, but with fraudulent balances. Deloitte resigned. Roughly twenty such companies have been delisted from the NYSE, AMEX and NASDAQ and all trading has been suspended.

But the biggest problem facing American companies trying to do business in China is not unreliable government statistics or fraudulent accounting. Without question, those issues take a backseat to intellectual property theft. The U.S. International Trade Commission estimated in 2009 that American companies lost $48 billion in sales from such theft. American movies and music are routinely pirated and then resold into the U.S. market. The look and feel of designer shoes, dresses and purses are copied meticulously, including the labels and packaging and sold for a fraction of the price of the originals. China is currently the world's second largest market for computer hardware sales, but only the eight largest for software. Nearly every technology company reports Chinese government agencies downloading software updates, despite never having purchased the programs. Obviously, the programs are being obtained illegally. Currently, American Superconductor, a manufacturer of wind turbines, is in the earliest stages of preparing for a trial against its third largest customer, Sinovel Wind Group, in which American Superconductor is claiming $1.2 billion in damages for stealing its technology.

Probably the most audacious example of intellectual property theft is the construction of three fake Apple stores in the city of Kunming. Every aspect of the stores, from signage, Genius bar,

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posters, shelving, counter displays and employee uniforms, is indistinguishable from the original.

Almost as problematic are the protectionist policies that the Chinese government has put in place. China does not simply encourage that products sold in China be made there, but also that they be conceived and designed there, a policy know as “indigenous innovation.” Hostility from local officials is especially intense in fragmented industries where Chinese companies are not dominant. WalMart serves as an interesting case study. Last year, WalMart was cited in the city of Chongqing for selling ordinary pork that had been incorrectly labeled as organic. Other foreign retailers, such as France’s Auchon or Britain’s Tesco have been cited for similar infractions, but have not been punished. By contrast, WalMart was forced to shutter 13 stores. Thirty-seven WalMart employees were arrested, and two of its highest ranking executives in China were forced to resign. In a survey released in April of 2011 by the American Chamber of Commerce in China 26% of American companies say that their business is being hurt by policies designed to favor mainland suppliers. More than half of respondents stated that since the 2008 global financial crisis, American companies cannot obtain the same licenses as their Chinese competitors, or the licensing process is considerably longer and more complicated. In fields ranging from renewable energy to mobile phones, the government has required American companies to turn over proprietary technology to Chinese companies as a precursor to doing business in China and has ordered banks and other financial service firms to limit use of foreign data security products.

As if questionable data and accounting, lack of respect for intellectual property law, and protectionist policies to protect local businesses do not create a difficult enough environment for American companies, China is also bedeviled by widespread corruption. Public surveys on the mainland since the late 1980s have shown that it is among the top concerns of the general public. Transparency International reported in November that Russian and Chinese companies are the most likely to use bribery. In popular perception, there are more dishonest Chinese Communist party officials than honest ones, a reversal of the views held in the first decade of reform of the 1980s. In the same way that we might pass around a new joke, Chinese citizens are fond of reciting shunkouliu, which are rhythmical, sometimes rhymed, popular sayings. Official corruption is their most frequent topic by far, as illustrated in the following.

Officials are addicted to money

While the people labor and sweat.

If something else counts, then it's funny

That no one's run into it yet.

Despite the huge number of obstacles, American companies are tripping over one another to get an early-mover advantage. After all, the world’s largest population, combined with a growth rate roughly three times that of the developed world, make the opportunity irresistible. It is estimated that U.S. companies invested approximately $48 billion, in China in 2009 (the latest year for which data is available), down slightly from $49 billion the prior year. Coca-Cola now employs a whopping 14,000 people in China. Proctor & Gamble is the number one consumer products company in China, with 8,000 Chinese employees. Caterpillar has 8,500 workers there. Merck, the pharmaceutical giant, has announced a worldwide reduction in force of 13,000 employees in an attempt to offset declining revenue from patent expiration, excluding China, where it is adding hundreds of workers to the 5,000 it already has.

It does seem inevitable that China will eventually be the world's largest economy. It is currently in second place, and will probably surpass the United States in about a decade. The lure of such a huge market is irresistible. But at its core, pursuing these future riches is analogous to growth stock investing. Huge expenditures must be incurred today to produce earnings at some point in the future, but the timing and magnitude of those income streams are extremely hard to predict given the unreliability of raw data. Even if the big picture turns out to be correct, not every company will prosper. In the late 1600s the New World seemed to offer opportunity analogous to what China offers today. The Mississippi Company was formed in France to exploit trade with Louisiana, and shares soared. But when it was realized that the value of those shares could not be justified by the earnings of the company, the scheme collapsed, dragging down the French economy in 1720. The completion of a transcontinental railroad in the U.S. in 1869 opened up the vast American West to potential development, but the remarkable growth that ensued did not prevent the Panic of 1873, when the collapse of railroad stocks prompted a deep recession. More recently, the advent of the internet has transformed almost every aspect of daily life, but again the reality could not live up to the early hype, as the tech bubble bursting of 2000 showed. These collapses occurred despite the fact that the macro view implicit in each case turned out to be 100% correct.

The irony of this is that these same companies, and thousands of others, are reluctant to hire anyone here in the United States, making this a jobless recovery. As justification, they cite a plethora of uncertainties. One is the uncertainty about the costs associated with the looming implementation of Obama Care. Another is the uncertainty about tax rates, with the possible expiration of the Bush tax cuts. If they are allowed to expire, the marginal tax rate on the highest earners will rise from 35% to 39%.

These same executives do not seem particularly disturbed that in China, tax rates are steeply progressive, with the highest rate being 45%. This is in addition to a 17% VAT. Moreover, tax rates are frequently changed by fiat. In June, 2010 the Chinese government imposed a 5% resource tax on coal and oil production, but only in the Northwest Xinjiang Uighur Autonomous Region. Impressed with the revenue raised, they extended this tax to 11 of the 31 provinces in December, 2010. In November of 2011 the tax was extended to the entire nation, and to cover all resource production. All this without any nationally televised Congressional debates. Talk about uncertainty.

And of course, there is the uncertainty in the U.S. of additional regulation. But even the most onerous proposed regulations are unlikely to include the jailing of company officials for mislabeling pork as organic (this in a country which permitted melamine tainted milk formula to cause the hospitalization of thousands of infants).

There is always uncertainty in business. In the case of the domestic economy, business leaders seem to have independently arrived at the conclusion that this is an unusually bad time to expand here. But just as theater-goers can simultaneously suspend disbelief and enjoy a nonsensical story about a forever young Peter Pan, these same executives have all decided the there is an irresistible opportunity in China, no matter the reliability of data or the capriciousness of the laws. Contrast this with Warren Buffett, arguably the greatest investor of all time, who is known for his preference for stable cash flows that he can purchase at a discount to their intrinsic values. He has recently purchased shares in Bank of America and IBM, and the entirety of Lubrizol and Burlington Northern, opting for the greater transparency and investor protections of the United States. Perhaps the Business Roundtable should start serving tea at future meetings.