The Dangers of Generalisation

Investors like to sort things into neat categories. It helps them make sense of a highly complex world. Categories like "Emerging Markets", "BRICs", and the "Fragile Five" have all been invented as easy-to-understand groupings of supposedly similar countries. Yet we have to be careful of such generalisations, because the more research you do, the more you realize that there are often more differences than similarities between these groupings.

Take "BRICs" as an example. Aside from the fact they are all large countries on the cusp of developed market status, you'd be hard pushed to find four more different countries than Brazil, Russia, India and China. Linguistically, culturally, historically, politically and economically they are actually about as different as you can get.

Let's look more closely at India and China. Far from being similar, India and China are so different they often look like negative images of each other. India is a raucous, noisy democracy; China is a single party system. India's development has been heavy on consumption, light on infrastructure; China's has been heavy on infrastructure, light on consumption. China has a current account surplus of around 2% of GDP; India has a similar-sized deficit. China has less than 3% inflation; India has over 9%. It's hard to see how the two can be squashed into the same artificial investment grouping when the fundamentals are this different.

Stock market performance also diverges hugely. Over the last 12 months, MSCI China has returned -0.41%, whereas India has returned 12%. So if you generalize about "BRICs" or "Emerging Markets", and you sell them as a group or buy them as a group, you will potentially miss out on big differences in performance between them. It is always worth doing the research necessary to figure out where money can be made, rather than making broad-brush decisions based on generalisations.

The difference between China and India's stock market performance is a good example of one of the most important things to understand about markets. That is that the second derivative drives performance. Let me explain. If you examine the economic fundamentals, you might conclude that China is a better investment than India. It has much higher GDP growth, a sounder currency, a current account surplus, a stronger fiscal position, lower inflation and lower interest rates. Yet the market has performed worse than India. Why? Because it is the second derivative that is important. What we mean by this is that it is not the absolute level of things that matters, it's whether at the margin they are getting better or worse.

Let's examine an example. China's GDP growth rate is high at 7.5% - much higher than India's and far higher than the developed world. But the rate of GDP growth has been steadily declining over recent years. This change in the second derivative of GDP – the rate of growth of the rate of growth – is one of the main reasons that Chinese equities have not done well over that period. India, on the other hand, has a large current account deficit. But at the margin, it has been improving recently, from around 5% of GDP to around 2.5% of GDP. This marginal improvement is one important reason the India equity market has done well.

Indonesia is another market which has done well recently for similar reasons to India. Indonesia on the surface looks very similar to India: structurally high inflation and interest rates; big current account deficit; weak currency. Yet its stock market has been the best in the region over the last 3 months, up 11%, beating not just the other Asian markets, but all the developed markets of Japan, Germany, the UK and the US too. This is because it has been improving at the margin from a very weak economic picture to a slightly less weak economic picture. Specifically, again like India, Indonesia has made big strides in narrowing its large current account deficit to a more manageable level. This has been achieved mainly by allowing the currency to depreciate and accepting lower economic growth.

Just as generalisation in the form of grouping countries or markets together can be dangerous, generalisation within a single market is dangerous too. China is an excellent example of this right now. In aggregate, the China equity market has performed badly, on concerns over the slowing rate of GDP growth and risks related to overly rapid credit expansion. If you had predicted this, and not held China in your portfolio, then you could proudly say that you had avoided investing in a market that has gone down over the last 12 months. Perhaps instead, you may even have invested in developed markets like the US, Germany and Japan, whose equity markets have all gone up around 25% over the same period.

But should you in fact be proud of this? Because the reality is that over the last 12 months, the China healthcare sector is up 115%; the China software and services sector is up 111%, IT hardware 53%, and the consumer services sector in HK (which encompasses the Macau gaming stocks) 73%. Those who like to generalize often refer to these sectors as the "new economy" or "privately owned" sectors. If you had focused your investment on this area, you would have done fantastically well – far better even than if you had invested in the developed markets mentioned earlier.

So generalizing at the country level is also a mistake, because it hides a wide variation in sector performance within the country. The poor performance of China equities in aggregate has been driven by the very large sectors such as banks (down 18% over 12 months), energy (down 21%), materials (down 20%), and telecoms (down 16%). These sectors are often grouped together by those who like to generalize as the "old economy" sectors or "state-owned enterprise" (SOE) sectors. These sectors, because of their size and therefore weight in the index, have outweighed the excellent performance of the smaller "new economy" sectors which have done so well.

The difference in performance between the "new economy" and "old economy" sectors in China is because the reform programme announced after China's recent 3rd plenum is all about transferring economic power away from those largely state-owned, old economy sectors towards the privately owned new economy sectors. China badly needs to rebalance the source of its GDP growth away from debt-funded investment in infrastructure, and towards consumption, in order to avoid a serious credit problem at some future point. Investors have been avoiding the sectors that will be negatively impacted by this rebalancing, and investing in the sectors that should benefit.

However, this trend cannot continue for ever, because valuation is important. If the 'new economy" sectors continue to go up in a straight line, they will become more and more expensive, and eventually there will have to be a correction. Equally, there must come a point where the "old economy" sectors have become so cheap that they are more than discounting the tougher times ahead. The PE for MSCI China in aggregate now is 9x, but the "new economy" sectors are trading much more expensively than that.

For example, healthcare is on 26x, consumer staples is on 27x, consumer services (Macau gaming) is on 30x, and software and services is on a whopping 53x. In contrast, among the "old economy" sectors, you will find that banks are on 5x, real estate on 7x, energy on 8x, and telecoms on 9x. So the big dilemma for investors in China this year is whether to continue to run the winners – that is, stay invested in the sectors that have done very well – or to rotate into some of last year's unloved sectors.

Perhaps the answer lies with our old friend the second derivative. If, at the margin, some of the old economy sectors are looking "less bad", and they are already very cheap, that could be enough to make them good investments in 2014. Examples of this could be sectors like cement, where consolidation driven by the government's need to remove capacity may be to the benefit of the surviving players in the industry, or perhaps selected banks where the fundamentals look not too bad and the valuations are supportive. Equally, if some of the "new economy" sectors are looking less good at the margin, and are already very expensive, then that could be a catalyst for profit taking. An example of this could be something like increased government focus on regulating internet finance, a recent but fast-growing part of the internet sector.

In conclusion, the best recommendation for the current year, then, is not to generalize; to do your research, or give your money to someone who can; to take a more balanced view between sectors, selectively moving some money from the "new economy" space back towards to the "old economy"; and at all times to remember – it's the second derivative that moves markets.

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