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A closer look at the Chinese tech sell-off

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I often use this blog as an opportunity to answer pressing questions from clients. And recently, it seems almost all the questions we are getting are about China – what is going on with Chinese stocks and whether investors should abandon them. The catalyst for these recent jitters: Last week, Chinese regulators surprised markets by publishing regulations requiring tutoring service providers to be run as not-for-profit entities. This triggered a substantial sell-off across Chinese equities.

What prompted these regulations?

First of all, I think it's important to understand the rationale for China's decision on for-profit educational businesses. Currently, it is very expensive for Chinese families to utilize tutors to help their children perform well during their compulsory years of education, but many families view it as a necessity to help their children succeed academically and be accepted at a highly regarded university. The Chinese government recognizes that this places a significant and unfair burden on families – and may be a hindrance to China's goal of encouraging couples to have larger families. China recognizes that it is in the best interest of the country that all its children have equal access to educational opportunities. It's clear that the Chinese government is willing to tolerate short-term volatility in order to achieve longer-term goals.

It's understandable that this regulation of the for-profit education industry, which includes the banning of foreign investors, would exert downward pressure on stocks in that industry. However, the reaction was far more broad-based: Chinese tech stocks and Chinese equities, in general, sold off indiscriminately. I suspect it's because this decision follows on the heels of a series of other regulatory decisions in recent months that impacted other industries. The objective of these regulatory actions is not to drive foreign investors from China – or for China to undermine its market economy. Rather, authorities seem to be doing what other countries have only talked about doing in terms of addressing issues that have arisen in recent years:

- **Financial stability:** China wants to ensure adequate risk controls for financial services companies, including sufficient capitalization.
- **Data protection:** Data security is an important issue for all companies and consumers, but countries have done little to protect data. Chinese policymakers believe data security is a national security issue, and as such, do not want foreign entities to have access to Chinese companies' data.
- **Break-up of tech monopolies:** Authorities are concerned that some companies may gain an unfair ability to set higher prices because they control an industry. They also want to ensure that smaller businesses are not at a disadvantage when competing.
- **Better conditions for workers:** China wants to ensure "gig workers" receive adequate treatment from employers, including earning a living wage and receiving health benefits.
- **Combating climate change:** The government wants to support a "greening" of the economy.

China seeks to calm investor fears

The Chinese government showed that investors matter by quickly pulling together a meeting last week between Chinese regulators and brokerage firms to help explain its most recent decision and to assuage fears. China Securities Regulatory Commission Vice Chairman Fang Xinghai reassured participants that Chinese companies will still be allowed to go public in the United States as long as they meet criteria set out by the Chinese government for listing. That doesn't mean we won't see more regulation going forward, as authorities think strategically about the longer term, but I would expect it to be targeted and based on China's focus on achieving higher-level goals.

My takeaway from this situation is that many Chinese equities, especially Chinese tech companies, have been unfairly punished by investors as a result of recent regulatory actions. However, that has created more attractive valuations. As of July 30, the trailing price-to-earnings (P/E) ratio on the MSCI China Index is 18.86, which compares favorably to that of the MSCI World Index at 26.07[1]. Rather than abandoning Chinese tech companies, I believe this is an opportunity for investors to look for buying opportunities, albeit through a discerning lens.

Notes

[1]Bloomberg L.P as of July 30, 2021

Important information

The MSCI China Index captures large- and mid-cap representation across China H shares, B shares, Red chips, P chips, and foreign listings (e.g., ADRs). With 495 constituents, the index covers about 85% of this China equity universe. Currently, the index also includes Large Cap A shares represented at 10% of their free-float-adjusted market capitalization.

The MSCI World Index is an unmanaged index considered representative of stocks of developed countries.

The price-to-earnings (P/E) ratio measures a stock's valuation by dividing its share price by its earnings per share.

Investments in companies located or operating in Greater China are subject to the following risks: nationalization, expropriation, or confiscation of property, difficulty in obtaining and/or enforcing judgments, alteration or discontinuation of economic reforms, military conflicts, and China's dependency on the economies of other Asian countries, many of which are developing countries.

Many products and services offered in technology-related industries are subject to rapid obsolescence, which may lower the value of the issuers.

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All investing involves risk, including the risk of loss.

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