How to Invest in Chinese Tech Funds

Understand China's managed economy before investing.

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By Dawn Reiss | Contributor

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As a country, much of China's rise to power comes from its large reliance on manufacturing that dominates so many industries worldwide. In less than 30 years, China has shifted its trajectory from one of the poorest nations to one where human capital accounts for 11 to 15 percent of China's GDP growth, according to the

Harvard Business Review.

"We will be feeling the ramifications of China's rise for the rest of the century," says Usha Haley, a professor at West Virginia University who has authored several books on business and trade in China, including "Subsidies to Chinese Industry."

But the world's second-largest economy has begun shifting to a more service-based industry where the supply of qualified skilled employees isn't meeting the growth and demand of the market.

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A flooded market. In the past five years, China has moved from the periphery of American investors and companies to its frontal vision fueled by a rapid acceleration over the last two years, Haley says.

Understanding the tech industry and how China's government regulates and infuses capital and does its financial reporting is complicated. Government subsidies are reported as profits, Haley says, which may give investors the impression of highly efficient companies drawing on core competencies but may be completely inaccurate.

"The data is downright misleading," Haley says. "There's a lot of money slushing around in the Chinese tech capital. China's government-backed venture funds raised more than $231 billion in 2015, five times the amount in venture capital anywhere else in the world and almost all of it is coming from the government with a little bit from private enterprise. Plenty of it is associated with unprofitable investments."

Haley says substantial money is coming from provincial and city governments such as Wuhan, the capital of Central China's Hubei Province's 200 billion yuan fund, which has become the largest, combining local and central government financing. The bulk of the capital comes from tax revenue or state-backed loans.

Since 2014 these funds have opened 1,600 high-tech incubators for startups, Haley says.

"The huge influx of cash flags the threat of boom-and-bust cycles like the government-led investments in China's solar and wind-power sectors," she says. "Inexperienced or corrupt managers will likely invest in dozens of regional copycats, unable to achieve economies of scale or scope for profitability. In reality, very few qualified startups actually exist in which to invest."

Haley points to ride-sharing company Didi Chuxing, formerly called Didi Kuaidi, that raised $3 billion in funding "without any feasible analysis," which is becoming increasingly common for Chinese tech sector investments.

"The Chinese government's idea is that if you throw good money after bad, something good should come out of it. But it doesn't always work out that way," she says.

Haley says the Chinese government floods the market with inferior products, which skews other cutting-edge technologies through the world because startups in other countries can't compete with the financial backing the Chinese are giving to their government-guided and financed industries.

Understand China's managed economy. The Chinese government can control and manage its economics because it has so many levers to pull, and more importantly, what they can report, says Anthony Glomski, founder of AG Asset Advisory in Los Angeles.

Glomski cautions that makes investing in China very speculative and akin to betting in a casino due to China's managed economy, lack of financial reporting standards and poor transparency.

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"We've never seen a truly bad economic reporting period, but the stock market goes haywire all the time," he says. "When you have that kind of excessive volatility it can lead to the mispricing of stocks."

Those boom-and-bust stock market cycles help to feed active managers, for funds like All-Stars Investment, the nearly $1 billion Hong Kong-based fund that includes Chinese technology and has already made a 12 percent return this year through September, Glomski says.

"That type of marketplace is more driven by emotion and creates volatility, which creates more opportunity for active managers like All-Star Investments to do much better than the Shanghai Index over a short period of time," Glomski says. "That's a driver trend for them and for all of their contemporaries."

Brian Thomas, AG Asset Advisory's chief investment officer, also says "a liquidity crisis could be consequential for the value of equity funds and their holdings if wealthy Chinese investors were forced to deleverage. This may lead to capital outflow from equity funds, removing their ability to take advantage of the volatility and instead contributing to the negative feedback loop impacting prices."

What else to consider. China may be best known for its BAT companies – search enging company Baidu (ticker: BIDU), e-commerce giant Alibaba Group Holding (BABA) – and tech giants housed in the Guggenheim China Technology exchange-traded fund (CQQQ)**.**

Jennifer Zhang, co-founder of PlusYoou and general partner of Cybernaut Zfounder Ventures and a venture capitalist in Los Angeles who is originally from Hangzhou, China, says investors should look toward trends in health care, consumer products, artificial intelligence and entertainment technology as well as investing in Industry 4.0 infrastructure, where robotics are remotely connected to computer systems equipped with machines.

Avoid investing in China's shared economy, since the time to invest was in 2014, she says, followed by the payments industry in 2015.

Although manufacturing has been the key driver of China's economy of growth for the past 20 years, as labor costs have increased much of the manufacturing is shifting to Southeast Asia and Africa as China has begun focusing on manufacturing more efficiently with higher quality products, Zhang says. The reason: many Chinese millennials are looking for higher-quality "lifestyle products," that offer brand identity, Zhang says.

At the same time, she says many Chinese consumers are unwilling to pay for things Americans are willing to purchase such as downloadable music, which means startups are becoming more creative in their financial partnerships and use of advertising dollars.

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"A lot U.S. entrepreneurs have never been to China and when they come here they are surprised by how big the markets are and how much capital we have," she says. "Chinese investors don't really want to copy something else. We are willing to invest in something new."

Top China Stocks

Stock Name	Price	1 Year Return
Baidu Shs -A- Sponsored American Deposit Receipt Repr 1/10 Sh -A- BIDU	Price $165.69	1 Year Return ▼19.84%
Alibaba Grp Shs Sponsored American Deposit Share Repr 1 Sh BABA	Price $93.41	1 Year Return ▲16.84%
China Mobile Shs Sponsored American Deposit Receipt Repr 5 Shs CHL	Price $54.06	1 Year Return ▼5.50%
JD.com Shs Sponsored American Deposit Receipt Lev III Repr 2 Shs -A- JD	Price $26.00	1 Year Return ▼13.30%
Ctrip.com Intl Shs Sponsored American Deposit Shares Repr 1/8 th Sh CTRP	Price $42.26	1 Year Return ▼24.31%
China Petro & Chem Shs -H- Sponsored American Deposit Receipt Repr 100 Shs -H- SNP	Price $69.27	1 Year Return ▲9.33%
China Unico(HK) Shs Sponsored American Deposit Receipt Repr 10 Shs CHU	Price $11.50	1 Year Return ▼9.46%
Netease Shs Sponsored American Deposit Receipt Repr 25 Shs NTES	Price $234.16	1 Year Return ▲45.19%
Melco Crown Ent Shs Sponsored American Deposit Receipt Repr 3 Shs MPEL	Price $19.36	1 Year Return ▲24.74%

Stock information as of November 22nd, 2016

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