TIFF INSIGHTS

On Tariffs and Consequences

July 2018

President Trump recently announced tariffs on certain Chinese goods, and China responded with tariffs of their own. As we write, the situation appears to be escalating, and the possibility of a trade war has markets concerned, including non-US markets and especially emerging markets, led by China. The Shanghai Shenzhen CSI 300 Index fell nearly 10% in US dollar terms in the last two weeks of June. While fears of a potential global slowdown seem to have hurt most markets, in this commentary we will focus on China, where TIFF's comprehensive portfolios have a meaningful overweight exposure vs. the MSCI All Country World Index (ACWI).

To cut to the chase, we intend to make no major portfolio changes in response to these tariff developments. We will explain why but let us start by reiterating the positive backdrop that we believe supports our position. First, China is the second-largest economy in the world and has the second-largest domestic stock market. It currently represents an approximately 4% weight in the ACWI and will likely become a mid-teens weight at some point under MSCI's gradual inclusion of China "A shares," i.e., those traded on mainland domestic exchanges. Second, approximately 75% of the trading volume on China's domestic exchanges arises from local retail investors. The US, which represents 54% of ACWI trading volume, is dominated by institutional investors. The lack of sophisticated market competitors in China suggests that the China-focused managers in our comprehensive portfolios should generate higher alpha than an equally talented manager focusing on the US. Finally, today Chinese stocks trade at price/earnings multiples of about 11x forward estimated earnings vs. US stocks at 17x. This strikes us as an unusually advantageous starting point.

While we cannot predict Mr. Trump's decisions, we are thinking carefully about the potential impacts of a trade war on our portfolios. When we refer to a "US-China trade war," we mean a situation in which the US places tariffs on Chinese goods exported to the US and China places tariffs on US goods shipped to China in an escalating tit-for-tat manner. In 2017, China was our largest trading partner, with about $130 billion worth of goods exported from the US to China and more than $500 billion exported from China to the US.

We and our China-focused managers, aligned as long-term investors, are less concerned about short-term perceptions than we are about the potential destruction of intrinsic value in shares owned on our members' behalf. The first-order consequences of a trade war may negatively affect companies in China that sell a meaningful percentage of their goods in the US. US tariffs on those goods would significantly increase prices, forcing US buyers to look for less expensive alternatives, thereby lowering US-based revenues for Chinese producers. If the Chinese companies in our portfolios were primarily engaged in exporting to the US, then perhaps we should reduce our exposure to China, as the intrinsic value of these securities has likely declined. Fortunately, we do not believe this is the case.

To better understand our China managers' geographic revenue exposures within TIFF's comprehensive portfolios, our team estimated the percent of revenue of each manager generated in the US vs. locally. Here's the result:

Revenue %	Manager A	Manager B	Manager C
China	84%	80%	80%
US	3%	3%	2%
Other	13%	17%	18%

Based on this analysis, a trade war would not seem to have significant first-order effects on the intrinsic value of our China holdings because only a small slice of company revenue is earned via sales within the US.

Second-order consequences of tariffs are harder to estimate but can be nearly as important as first-order effects. Suppose that a Chinese company does not export to the US directly, but their domestic customers do; then, US tariffs could affect the intrinsic value of that company's shares. There could be other unusual second-order consequences. However, we recently spoke with our China-focused managers to better understand the situation and their views on first- and second-order consequences. They agreed that our analysis of first-order consequences related to intrinsic value was consistent with their own beliefs.

Regarding second-order effects, one manager noted that the situation is more complicated than many believe. One Chinese exporter, for example, generates a significant proportion of revenue from the US, but the revenue results not from exports but from sales by a factory the company had built in the US, which would not be subject to tariffs. An analyst not thinking too deeply might sell the stock even though the company's products won't be subject to import tariffs. Such thinking can create fundamentally unwarranted stock price declines.

Another manager noted that it focuses on domestic companies that sell goods and services benefiting from highly *inelastic demand,* meaning that as prices change, customers don't alter the quantity purchased. The companies in this manager's portfolio happen to focus almost entirely on the Chinese market, and the manager believes first- and second-order negative consequences will be minimal. The third China-focused manager believes that US tariffs will accelerate the pace of local innovation, benefiting Chinese companies over the intermediate term.

Each of our China managers is currently finding opportunities to invest in companies at prices they believe represent good entry points. In some instances, we have observed these managers engaging in counter-cyclical capital allocation, including deploying cash into high-quality A-share (domestic) companies that have sold off recently to levels they believe are overdone.

While the motivations of world leaders, the macro-effects of tariffs, and the direction of sentiment are beyond our ability to predict, we do spend time talking with managers about the micro-economic consequences of developments like these on our portfolios. As of now, we suspect that rather than trimming our exposure to China, we may have an opportunity to add capital at increasingly attractive valuations.

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