



Excerpt from the *Seafarer Funds Semi-annual Report*

Letter to Shareholders

Period Ended October 31, 2017

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Chief Investment Officer

Dear Fellow Shareholders,

I am pleased to address you again on behalf of the Seafarer Funds. This report covers the first half of the 2017-18 fiscal year (May 1, 2017 to October 31, 2017).

It is not an accident that you hear so much about China in the news these days. Within the developing world, it is situated at the very center: it has the largest population; it possesses the largest economy, and the largest accompanying financial markets; it enjoys the greatest absolute store of wealth and power. Its influence dominates the rest – politically, economically and, increasingly, culturally. In many ways, for better or for worse, China serves as a model for development for many other emerging nations.

A great deal of change is taking place in China now, so I will use this letter to offer my perspective on the evolution of the place known as the “Middle Kingdom.”

My China Dream

Throughout my adult life, I have been an interested observer of China. I studied economic development in school, and was in awe of how a nominally communist country had harnessed market forces to lift hundreds of millions of people out of desperate poverty. When I graduated from college in 1996, I sought work in Asia. I wanted a job where I could study China’s evolution and emergence firsthand. I worked in Southeast Asia for two years, and the closest I came to the mainland was through several extended trips to Hong Kong for business.

In 1998, I returned to the U.S., and I sought a career in investment management. I was determined to work for an investment management firm focused on Asia. I was convinced that China was both the most important and the most under-appreciated and misunderstood market in the world. I thought China’s rise as an economic power would dramatically re-shape the world during my lifetime. I hoped then – as I hope now – for peace, progress and prosperity in the Middle Kingdom.

Over a decade later, in 2010, my work took me to Shanghai when the city was hosting the World Expo. The Expo featured pavilions representing nations from around the world. I toured the host's pavilion and viewed a special exhibition dedicated to "The Chinese Dream." One portion of the exhibit offered an animated glimpse of the future. It depicted gleaming, orderly, highly developed cities. They were free of pollution, and resplendent in greenery and blue skies. The society seemed too controlled and orderly for my taste; nevertheless, it was a powerful and inspiring vision, even if it seemed far-fetched at the time, given that China was choked with pollution, and its development was far from complete.

Still, the Expo had demonstrated that the Chinese people had made a great deal of progress over the preceding three decades. Through hard work, competition and economic liberalization, millions had earned better lives and livelihoods. The communist party had undertaken small-scale experiments with modes of governance that allowed for greater openness. I felt as though a realistic hope hung in the air, penetrating the smog.

At the time, I had only a passing knowledge of Xi Jinping, the man who would become China's next President in 2012. I later learned that Xi had adopted "The Chinese Dream" as his slogan to guide the nation's development. I suspect he had a substantial hand in the exhibit I saw in Shanghai in 2010: it was his Dream, and it was on display at the Expo.

When Xi assumed the Presidency in the autumn of 2012, I wrote a [letter to the shareholders](#)¹ of the Growth and Income Fund, in which I discussed China's "bright prospects" and its "dark clouds." I saw several looming problems for the country. However, my hope rested on a simple idea: Deng Xiaoping started China on a path toward greater social and economic freedom. As long as China remained on that path, growth would continue, and prosperity would ensue.

The Right Plan

My optimism stemmed from the fact that China had publicly expressed an intent to pursue a more "balanced" economic model – a model that placed greater emphasis on the domestic consumption of goods and services, rather than an economy dependent on manufactured exports and the construction of large-scale infrastructure (e.g., roads, bridges, ports, cities).

I was convinced that if the country pursued re-balancing, it would unlock additional potential to grow, and help the country avoid the "middle income trap." The "trap" refers to a typical feature of many emerging markets. Such countries initially manage to improve the average income per capita, but due to declining returns to scale, development is often arrested at a middling level, before incomes reach thresholds associated with richer, developed nations.

At that time, my analysis suggested that China had the right development plan – a plan to undertake economic reform, unlock new growth potential, and avoid the "trap." The more I understood of China's plan, the more impressed I grew. The plan was comprehensive; it was clearly the product of careful deliberation, designed to address many of the concerns raised by external critics; and it seemed to represent the consensus view among China's leadership about how to move forward. I knew the underlying reforms would be difficult to implement, but I thought they were exactly what was required to sustain the country's long-term growth and development.

In the spring of 2014, I wrote a [letter to shareholders](#)² in which I spelled out those reforms underway in China. This is a reproduction of the list of the reforms from that letter:

- A substantial (but unfortunately not exhaustive) anti-corruption drive.
- Liberalization of the local currency and of interest rates within the banking system. Both are "backdoor" reforms of the domestic banking sector.
- Recapitalization of the domestic banking system to address financial weaknesses.
- Major stock market reforms, including: enhanced access for foreign investors via the "through train" policy, new mechanisms for companies to issue capital, and a liberalized market for initial public offerings (IPOs).
- Major reforms to reduce excess capacities within state-owned enterprises.
- Modernization of provincial governments' finances, possibly culminating in the authority to levy local taxes (i.e. property and sales taxes), and the authority to issue municipal-style bonds.
- Liberalization of most key input prices, especially energy and natural resources.
- Environmental regulation, targeting sharp reduction in carbon emissions, with severe penalties for polluters.
- Reformed property and land use rights.

- Reform of the hukou (“household registration”) system. Hukou is a set of identification documents, somewhat like a domestic passport. The hukou system defines a household’s civil, economic and legal rights within a given municipality, broadly analogous to a locally-based entitlement scheme.
- A major overhaul of the national healthcare delivery system.
- Relaxation of the “one child” policy.

At the time – and unlike today, apparently – there was a great deal of skepticism regarding China’s economic and financial stability. However, I was reasonably confident that China would implement most of the reforms above, and confident in China’s future, I encouraged investors to peer over “China’s Great Wall of Worry.”

A Different Path

During his first five-year term, Xi led China on a path quite different from the one that I described in the 2014 letter to shareholders. His agenda had only a passing resemblance to the plan that I thought reflected the consensus of China’s leadership, and which I believed to be essential to the country’s future. Despite rhetoric to the contrary, economic and political reform largely stalled during Xi’s term. Some modest reforms were activated, but with little vigor; the plan I thought so critical for China went mostly un-implemented.

Instead, Xi placed a clear emphasis on three main objectives: purging corruption from the communist party; launching Belt and Road, a vast international program to spur investment and trade links between China, central Asia and Europe;³ and a major effort to reinvigorate of China’s military. The first project tackled the endemic corruption at every level of the communist party; however, it also appeared to permit Xi to remove his political enemies. The second program gave China a means to build economic, strategic and military ties with nations on its southern and western borders, while stimulating infrastructure construction, lending and investment. The third project sought to cut corruption in the military, while new investments in armaments and fleets allowed China to project newfound strength and power in the South China seas. This in turn has fomented conflict with other nations, including Japan and the U.S.

At the same time, Xi took steps to consolidate his personal power and control over the party in a manner not seen

since Mao Zedong. This was visible when the National People’s Congress convened in 2017 to nominate Xi for a second term as president, as expected. Rather unexpectedly, Xi had his name and his personal doctrine codified in the communist party’s constitution. His doctrine is known as “Socialism with Chinese Characteristics for a New Era.”

A New Era

Apparently, such codification has occurred only twice before in modern China: for Mao (during his life) and Deng (posthumously). The act was more than symbolic: it conveyed a degree of elevated personal power and authority to Xi that no ruler has enjoyed since Mao. It appears that Xi no longer serves the communist party within China; rather, it seems he has the power to define it, and his leadership over the party is absolute.

Xi’s New Era doctrine is only a vague vision at this time, but it is sweeping in its scope, and its main thrust is to install China as a global superpower alongside the United States. Xi has announced goals to reform the economy and the country’s governance, but the New Era’s main ambition is to cultivate influence and project power around the world. Gone are the days of Deng’s policy, which was to remain independent, peaceful, inward-looking, and to keep a low profile. Xi is prepared to lead the nation in a “tireless struggle” to stand “tall and firm in the east.”⁴

To underscore the extent of his newly accumulated power, Xi again broke with precedent, and did not name a successor during the recent congressional convention. His apparent aim was to enjoy greater freedom to advance his “New Era” agenda, as any successor would inevitably detract from Xi as his second term drew to a close. Xi went unchallenged in public.

Xi may yet name a successor, at a time and place of his choosing. However, many suspect he will not do so, preferring to seek a third term. If so, Xi will break a third precedent meant to check the abuse of power. In post-revolutionary China, only Mao formally ruled beyond one decade.

Requiem for My Dream

To be candid, this was not what I had dreamt for China. I had hoped the country would rigorously implement the original package of reforms, thereby sustaining its growth.

I had hoped the country would move slowly toward an open system of government – perhaps one that offered greater personal liberties, basic self-expression, and possibly even a limited form of representation.

Instead, Xi has pursued reforms half-heartedly, preferring to focus on the accumulation of political power, while shielding domestic industries from competition. His administration has made limited progress toward a number of elements within the original plan, but that progress has fallen well short of my expectation. He has invoked China's security apparatus to silence anyone that dares critique his administration openly. Meanwhile, the economy has remained dangerously reliant on excessive credit expansion to stimulate growth. In summary, the past five years fell far short of what I had hoped for China, and I am concerned as to whether the country will ever reach its potential.

Not all the news is bad, though. Happily, Xi has brought a needed dose of stability to international affairs, wisely seeking to expand China's influence by remaining open to foreign alliances and trading partners. As the U.S. has receded from the international arena, China has advanced. Even as I write now, China has announced a sweeping set of reforms tied to foreign participation within the domestic banking system, lifting previous restrictions on ownership. The reforms may bring much needed change and foreign competition to the financial system. While I have not yet had time to review the details, the announcement cements Xi as a bold and thoughtful leader, if not a zealous reformer. While Xi's first term left much to be desired with respect to the pace and quality of reform, perhaps there is room for hope.

Still, I worry about Xi's pursuit of absolute power, and the instability it might invoke. I never suffered from any illusion

that China might adopt a Western-style democracy. At the same time, I never thought the country would vest such immense power in one person. Though Xi's political ascent has gone unchallenged in public, I suspect a great deal of strife simmers below the surface. Furthermore, such centralized decision-making might detract from long-term economic efficiency. As a consequence, I worry the "New Era" is more susceptible to large-scale economic or political crisis.

China's rise is nearly inevitable in my view. I remain convinced its ascent will shape the course of world events for the next two decades, for better or worse. Xi's will to determine China's future is absolute and unshakeable. Thus far, he has exhibited a stable and carefully calculated mode of leadership. Yet by accumulating such personal power, he has definitively broken with China's past, and initiated a third era in China's modern history.

China is not the country I dreamt it might become. China's economic rise was the product of policies that began under Deng in the late 1970s; but a new era has arisen, and any assumptions we might hold about the Middle Kingdom must be revisited, if not cast aside. We must all watch carefully what happens next, and take nothing for granted, as the country's past is not necessarily a reliable guide to its future.

We thank you for the trust you have afforded us, and we appreciate the opportunity to serve as your investment adviser in the emerging markets.

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¹ www.seafarerfunds.com/letters-to-shareholders/2012/10/semi-annual#chinas-future

² www.seafarerfunds.com/letters-to-shareholders/2014/04/annual#great-wall

³ The Belt and Road Initiative was announced by China's President Xi Jinping in 2013. The official name for the initiative is "The Silk Road Economic Belt and the 21st Century Maritime Silk Road."

⁴ Tom Phillips, "Xi Jinping Heralds 'New Era' of Chinese Power at Communist Party Congress," *The Guardian*, 18 October 2017, <http://www.theguardian.com/world/2017/oct/18/xi-jinping-speech-new-era-chinese-power-party-congress>.



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