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Princeton's Burton Malkiel says U.S. investors are underweight China

By Barbara Kollmeyer, MarketWatch
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LOS ANGELES (MarketWatch) -- When it comes to China, history is bound to repeat itself and investors should be ready.

"People don't realize that in 1820, China was not only the most populated nation in the world, not only with the most land area, but was the greatest economic power in the world," said Princeton University Economics Prof. Burton Malkiel, who had a packed room of portfolio managers, analysts and certified financial planners hanging on his every word Wednesday evening at a presentation for the CFA Society of Los Angeles.

And in 20 years, China will once again claim that title, hence the need for investors to make sure they've got the proper exposure, said Malkiel, who wrote the recently published, "From Wall Street to the Great Wall: How Investors Can Profit from China's Booming Economy."

Continued strong economic expansion will make this prediction a reality, said Malkiel, who noted explosive growth in China the last 25 years, averaging 9% to 10% annually. In 2006 and 2007, growth exceeded 11%. "No nation in history has ever grown at this sustained rate," he said.

Much of that growth owes to the culture of the people, a key reason for his bullishness. "The hard-working Chinese energy makes New York look like a sleepy town," he said.

Malkiel said investors who can only see as far as the 2008 Summer Beijing Olympics should be looking ahead to even bigger events such as the 2010 World's Fair, due to be hosted in Shanghai and expected to be the most spectacular in history.

But he also points to several other factors that support the growth picture: development and urbanization of the country's Middle and Western regions, a large and increasingly educated labor force, continued infrastructure investments, the government's determination not to repeat past mistakes and also its unwavering belief that China will be a major power.

"They know they were the greatest country in the world," said Malkiel. "They'll do it again."

High, but bumpy road to China

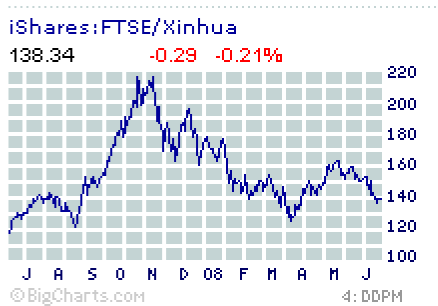
Of course, he's addressing a market that has had a rough ride this year -- China's Shanghai Composite is down 31% year-to-date. It's suffered a series of disasters such as the brutal winter storms that sapped the nation of power and Monday's devastating earthquake that rocked southwest China, killing more than 50,000.

Still, China keeps on coming, with data this week showing factory and land investment in the country soaring 25.7% in the first four months of the year, despite efforts by the government to cool the economy.

Malkiel said the dip in China stocks as of late may prove an attractive entry point, but admits that investing in the country is "complicated and risky," which has left many far too underweight the country.

Aside from market ups and downs, he said risks include some geopolitical tensions with Taiwan and Japan, environmental issues, corruption and an uneven distribution of income, though he said none of these would sway him from the country right now.

Still careful selection of China stocks is key, especially when it comes to the jittery investor. "The best that China has to offer investors is a mix involving direct and indirect shares. It's a lower-risk way of getting involved," he said.



Malkiel prefers "H" shares, those companies incorporated in China and listed in Hong Kong and on other foreign exchanges, along with "N" shares, Chinese companies listed in New York, which have the benefit of full regulation. He finds China "A" shares, which are listed and traded in mainland China, less attractive as they're very difficult for average investors to buy.

He said investors could get exposure to China via iShares: FTSE/Xinhua (FXI) , which he said has performed better than most managed China funds and tracks some of the country's largest and most stable companies. Several H shares are offered in the iShare, such as Ping An Insurance Co (HK:2318: news, chart, profile) and CNOOC Ltd (HK:883: news, chart, profile) . That fund is down 7.1% year-to-date.

He also likes China real estate, owing to infrastructure growth in the country and increased urbanization, and suggests a way into that via Claymore/Alpha China Real Estate (TAO) , a fund that got its start late last year. That ETF is down 17.5% year-to-date.

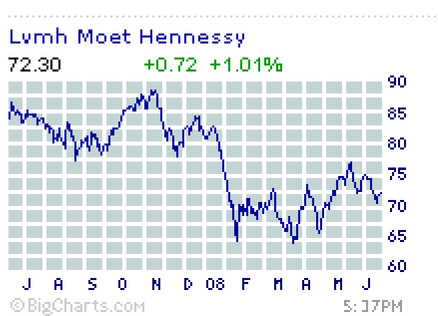
Malkiel is also the author of "A Random Walk Down Wall Street," first published in 1973, in which he contended that all markets are "efficient." The book is touted as the foundation for today's index-fund investing.

Backing into China

Malkiel's strategy also involves indirect investing, which might cater more to those investors who really are reticent to put too much money into China. He suggests investors buy shares of international companies that benefit from involvement in China.

Examples include Yum Brands Inc. (YUM) , which owns Kentucky Fried Chicken, now found all over Shanghai, and has a chain of very successful, family-style Chinese restaurants. While first-quarter same-store sales in the U.S. this year grew just 3%, same-store sales in mainland China climbed 12%.

Another example, is French luxury-goods group LVMH Moet Hennessy (FR:012101: news, chart, profile) . Its "Louis Vuitton label "sells more genuine handbags in China than in Europe," he said, which taps into a growing desire for luxury goods in the country. LVMH said its first-quarter sales were indeed driven by Asia, with even champagne sales making good progress in that region despite an overall slowdown for its wine and spirits unit.



Other companies tapping into China include mining giants Rio Tinto (UK:RIO: news, chart, profile) and BHP Billiton (BHP) , the latter of which saw shares soar earlier this week on speculation China may take a stake in the Anglo-Australian miner.

More on Malkiel's radar with that China connection include: The Coca-Cola Company (KO) , FedEx Corp. (FDX) , McDonald's Corp. (MCD) and PepsiCo Inc. (PEP) .

Malkiel said while he's not a market timer, investors must be committed for the long haul in China, especially as the market goes through periods of ups and downs. He said investors should back in slowly with dollar-cost averaging, a technique in which investors would spend a fixed dollar amount at regular intervals on a particular investment or part of a portfolio, regardless of the share price.

Barbara Kollmeyer is an editor for MarketWatch in Los Angeles.