Investors Getting Schooled?

3 ways to avoid investment pitfalls in China. Lessons in sustainable investing from the Chinese education crackdown.

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On July 23, 2021, the Chinese government released a document titled "Ideas on reducing homework and the burden of after-school tutoring for students during the years of compulsory education."

Section 4 of the 8 section document set out a ban on for-profit tutoring and directly banned listed companies from the tutoring business for core academic subjects. The news hit the stocks hard. Companies such as New Oriental Education (EDU) traded down -54.2% and TAL Education was down -70.7% on the day.

Reaction from the international news cycle to the new Chinese regulation was predictable. The commentary included many stories on the "end of capitalism" in China and that the market was “uninvestable.” The general focus was a curb on private enterprises. These narratives are too short-sighted and miss both practical reality and the bigger picture.

1. Social issues can have a bigger impact than environmental and governance

One important principle in fundamental investing is that companies represent more than tickers on a screen. Businesses operate in the real world with people - employees, suppliers, customers, and regulators. As we look for long term sustainable investments, we need to analyze these stakeholders and how they intersect.

Social factors are often not fully considered because they are difficult to assess. Unlike environmental or governance factors, social sustainability can be hard to quantify.

As practitioners, this is not a surprise. There are many questions on social impact and social risks with no easy answers. For example, are universal standards or local cultural factors more important? How do you address social inequality taking into account aggregate growth? What if a company is in the near term providing benefits to society such as jobs and general welfare, while over the longer term generating negative externalities?

Chinese policymakers don't make decisions in a vacuum. They have been asking questions about the for-profit tutoring industry and the unequal educational opportunities for poorer and low-income families. The Ministry of Education even voiced concerns that the industry was siphoning away teachers. The high costs of education made it hard to have more children.

Over the past decade, we have followed the education sector closely met with the senior management of many of the companies. In the past, we have even been shareholders. In more recent years, we have become wary of the social impact of the for profit education business practices and cautious of the sector.

2. Business models matter: the danger of profit maximization without considering social impact

We first witnessed the beginning of this "crackdown" on for-profit education in the fall of 2018. Reading about cases of child abuse and unqualified teachers, it seemed to us the government had to act. They banned private kindergartens from going public and restricted for-profit elementary schools in general.

Shortly afterward, we were invited to a seminar with industry executives and lawyers for several large law firms to discuss the regulations. The expert opinion was that there were numerous loopholes. There were legal maneuvers such as organizing the local operating business as a non-profit while paying licensing fees. While this was supposed to reassure investors, we walked away more worried.

At the heart, there was always something that bothered us. Our own personal experiences contradicted the model of education as a profit-maximizing endeavor. We all graduated from public or non-profit institutions. We've also had the privilege to know many friends who used their success in business to generously support education. They have funded schools, universities, research institutes, countless scholarships, and mentorship programs. Beyond serving as role models, it illustrates that education depends on external support.

After the initial crackdown in 2018, we saw continued regulatory attention. There were numerous public policy speeches as well as local news coverage on the large amounts of money being spent on supplemental education. While public education by law should be free from ages 5-15, it became a huge burden for families. These tutoring companies became predatory and preyed on the fears of parents instead of being good for kids.

The Chinese educational system has been competitive, rigid and test-oriented. Parents and educators have realized the negative aspects of the system. Children are pressured to join endless afterschool tutoring and supplemental activities. This comes at a great financial cost and at the expense of creativity and free play. Educational spending ranked with housing and healthcare as top economic worrries. While many families recognize the problem, they are afraid to get off the hamster wheel for fear that their child would get left behind.

Going back to the policy announcement, most financial analysts or commentators focused on the ban on for-profit tutoring companies and missed the bigger picture. The government's goal is to lower parental stress and encourage healthy well-rounded kids. This is something they have openly discussed for several years and is not a surprise.

The ban on tutoring was only one of eight sections in the policy document. They are serious about reform. We see this in the details. For example, it includes guidance that homework needs to be developmentally appropriate. Parents should not need to do it for their kids. The nature of the homework should be personalized and flexible rather than repetitive and pointless. It also states (in section 2.8) if a child cannot finish the homework after working hard on it, they should still go to bed on time instead of staying up.

It's a strikingly progressive educational philosophy. There is also guidance on improving the public education system to provide better after-school services and free supplemental educational resources if students need them.

3. China policymakers are taking action on ESG issues

While we are sympathetic to the pain of surprised investors who suffered losses, we saw this coming. Others were surprised by the swiftness with which the policymakers made the move. We have seen China move fast before. While the for-profit education businesses were not explicitly on our exclusion list, we did not invest because of the clear policy risk.

Why would they prioritize this as an important reform? It shows us they think the problem is urgent. The Chinese economy has had a very successful four-decade run since Deng Xiaoping's economic liberalization. They want it to continue.

Deng famously said that to open up and grow the economy, the government would "let some people get rich first." This was a clear sign that the new economic model would prioritize growth. We know that model succeeded and the pie has gotten larger for the entire country. Now it needs to be sustainable. With this policy they want to ensure open access to educational opportunities regardless of family economic circumstances. We expect the government will continue to address social reforms.

There are different attitudes toward sustainable investing around the world. The conventional wisdom has been that sustainable investing is more advanced and important to consider in Western countries while Asia is lagging. China's recent reforms show that may not be the case anymore.

Sustainable investing in the West has largely been a bottom-up push from fund managers, asset owners and the investing public for change. In China, we are seeing a different approach with policymakers as the first movers. The relatively swift actions taken to reform for-profit education is an illustrative example.

Problems with for-profit education are not unique to China. Harvard Law School has a "Project on Predatory Student Lending" which started in 2012. It's an important story worth reading outside the scope of this note. (1) Most recently on July 15, 2021 the US Department of Education finally filed a motion to drop its appeal on a case originally from 2018. It's a long process across different administrations and multiple rounds in court.

Each country has its own regulatory and legal system. We expect as Chinese policymakers identify important ESG issues they will take aggressive action to address them. As investors, we need to stay ahead of the curve.

Creative destruction, challenging vested interests and reinvention is difficult. Educational reform in any country is a major project. Recalcitrant educational bureaucrats and institutional inertia can make change difficult. If the Chinese government successfully implements educational reform, it could lead to another generation of economic prosperity. We will see if they can make it happen.

(1) https://predatorystudentlending.org