Implementation Insight

Rethinking China's Role in Emerging Market Equity Portfolios

Contents

bfinance is an award-winning specialist consultant that provides investment implementation advice to pension funds and other institutional investors around the globe. Founded in 1999, the London-headquartered firm has conducted engagements for more than 300 clients in 35 countries and now has eight offices in seven countries. Services include manager search and selection, fee analysis, performance monitoring, risk analytics and other portfolio solutions. With customised processes tailored to each individual client, the firm seeks to empower investors with the resources and information to take key decisions. The team is drawn from portfolio management, research, consultancy and academia, combining deep sector-specific expertise with global perspective.

Contact details
Robert Doyle, Director, Public Markets, rdoyle@bfinance.com
Weichen Ding, Senior Associate, Public Markets, wding@bfinance.com

Why read on?

Investors are reassessing their approach to investing in Chinese equities, supported by fundamental shifts in asset management offerings.

The growth of China's equity markets, both in terms of global index weightings and overall market capitalisation, calls for an **ongoing re-evaluation of investment strategy**. While a 2020 survey by Greenwich Associates and Matthews Asia[1] reveals that 70%* of institutional investors still use Global Emerging Market (GEM) equity strategies as their primary source of China equity exposure, bfinance clients have increasingly moved towards implementing **dedicated China allocations**. This can involve adding A-Shares (onshore equities) alongside GEM strategies, since the latter are primarily focused on offshore securities, or carving out all Chinese equity exposure to be managed through "China All-Shares" strategies which blend onshore and offshore together.

Those that examine the implementation options for Chinese equity investing will encounter a universe of available products and strategies that has changed substantially during the last few years. For example, there is a rapidly growing contingent of All-Shares strategies suitable for institutional clients: these currently number below 20 but manager searches indicate more than 30 firms bidding to attract clients in this space, including those who are willing to launch funds or create customised mandates that blend their existing onshore and offshore capabilities. In addition, there are over 60 active *A-Shares managers (see A-Shares Sector in Brief)* and, of course, a very established roster (>70) of Offshore China Equity managers.

When considering the options, investors should pay close attention to the complementarity between GEM equity strategies and the potential China equity strategies, with a view to minimising overlap and portfolio inefficiencies. For example, dedicated A-Shares strategies tend to pair well with GEM strategies from a correlation standpoint, whereas All-Shares strategies may sit better alongside a "GEM ex-China" strategy. Indeed, we already see a few (<10) GEM equity managers offering 'GEM ex-China' strategies with this pairing in mind, while many more GEM managers could create an ex-China mandate for investors who wish to take this approach.

In this brief report we consider the case for dedicated China exposure in some form, the different portfolio construction approaches available, and the latest data on asset management offerings available to investors. One thing is clear: staying on the side-lines of the world's second biggest equity market is becoming increasingly untenable.

Jargon buster

A-shares: Chinese companies listed on the mainland (Shanghai or Shenzhen). Available to foreign investors via the Qualified Foreign Institutional Investor (QFII) scheme or Hong Kong Stock Connect. RMB-denominated.

H-shares: Chinese companies listed in Hong Kong. HKD-denominated.

ADRs: US-listed securities that represent Chinese companies. USD-denominated.

And the rest…: B-shares are few in number (97 stocks vs. 3680 A-shares), listed in China but denominated in HKD or USD. **Red-chips** and **P-chips** are companies incorporated in Hong Kong, but whose primary business interests are in mainland China (and, in the case of P-chips, controlled by mainland Chinese individuals).

[1] Crafting the Optimal China Allocation Strategy, Greenwich Associates, April 2020

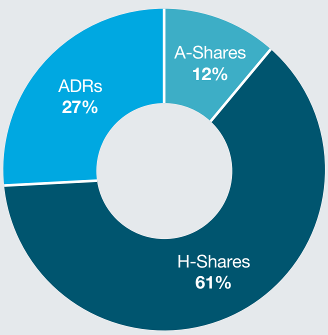
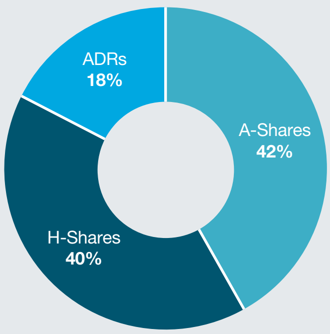
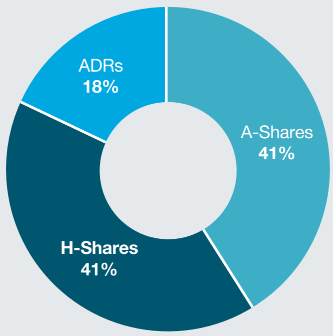
Portfolio possibilities

There are multiple approaches for achieving Chinese equity exposure, each of which brings advantages and disadvantages.

Three potential routes include:

- Investing in China via Global Emerging Markets (GEM) strategies.
- Creating a satellite China A-shares exposure to complement an existing GEM allocation.
- Introducing a standalone China All-Shares allocation alongside a GEM-ex-China strategy.

FIGURE 1: STRATEGIES FOR OBTAINING CHINA EQUITY EXPOSURE (IMPLIED CHINA WEIGHTING BASED ON MSCI INDEX).

Strategy	**100% GEM**	**85% GEM, 15% A-Shares**	**55% GEM ex-China, 45% All-Shares**
Implied China weighting	35% (per benchmark. In reality there is substantial variation between managers)	44% (per benchmark)	45% (determined by investor)
Pros	*Simpler governance and oversight with fewer managers. *China weighting is increasingly substantial, supported by greater index inclusion. *Outsources decision on China allocation (pro or con depending on investor).	*Large roster of active A-Shares managers (Figure 2) demonstrating strong alpha generation (Figure 5). *Targeted solution to boost onshore exposure that may be lacking in GEM.	*Unified China approach enables relative value decisions on onshore vs. offshore. *Maximises potential A-shares exposure as a proportion of China. *Considers China as a long-term strategic allocation, like US/Europe/ Japan.
Cons	*Lack of China A-Shares expertise (typically 2-3 analysts). *Little onshore exposure. *Bias towards a few large cap stocks for China A (see p. 8). *Underweights fast-growing sectors such as Consumer Staples and Health Care. *Still underweight China vs. market capitalisation.	*China exposure divided between GEM manager(s) and A-shares manager(s), limits ability to express relative value views on onshore vs. offshore at sector and stock level. *Investor determines weight towards A-shares (pro or con depending on investor).	*Historically narrow manager universe, although this has broadened substantially. *Few established GEM ex-China products (<10), though many managers can theoretically offer.
Implied composition of China equity exposure			

Source: bfinance

Portfolio possibilities continued

These options, which are discussed further on pages 8-10, minimise the portfolio overlap that other combinations – such as GEM plus China All-Shares – would produce. One can of course think about further combinations that provide sensible portfolio construction.

Over time, we anticipate a continuing migration away from obtaining China exposure solely through GEM strategies and towards China strategies, particularly those with a strong onshore focus. This move, however, depends on three factors: the **overall level** of exposure to China that the investor wishes to achieve, the **type** of exposure that the investor wants (e.g. onshore stocks vs. offshore) and the **credibility** of the China specialists relative to the China portion of active GEM portfolios.

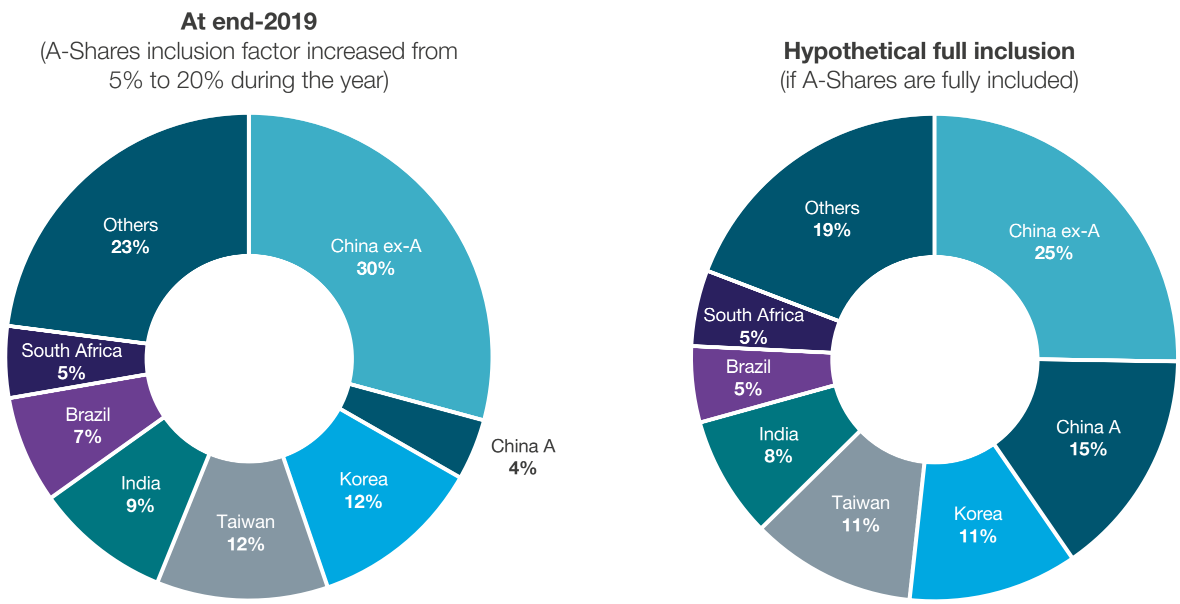
Today, the demand for establishing dedicated China allocations is heavily influenced by the second factor: the desire to improve exposure to onshore equities, which tend to receive very limited coverage in GEM strategies although they occupy an increasing role in global indices (Figure 3). However, the third factor – the availability and credibility of strategies – is also of crucial importance. The subsequent sections of this article deal with these three factors in turn.

FIGURE 2: EXPOSURE OF THREE CHINA INDICES TO CHINA EQUITY TYPES, PLUS ACTIVE MANAGER COUNTS

	Exposure as of December 2019			
Index	**China A**	**China H**	**ADRs**	**Number of active managers**
MSCI China A Onshore	100.0%	0.0%	0.0%	More than 60
MSCI China	11.7%	61.1%	27.2%	More than 70
MSCI China All Shares	40.5%	41.1%	18.3%	Fewer than 30

Source: bfinance, Bloomberg, eVestment

FIGURE 3: CHINA IN THE MSCI EMERGING MARKETS INDEX



Source: bfinance, Bloomberg. MSCI began to include A-Shares in the MSCI Emerging Markets Index in May 2018 with an inclusion factor of 5%. This increased three times in 2019, ending with an inclusion factor of 20%. If A-Shares were fully included they would represent 15% of the index.

Why China? Why onshore? A brief recap

The growth of the world's second largest equity market and its rising prominence in MSCI indices are often cited as grounds for developing a clearer strategy around this sector.

More recently, the market turmoil of 2020 has showcased the divergence between Chinese equities and Global Emerging Markets: while the MSCI EM index lost 23.60% in Q1, the MSCI China A index lost just 9.72% and the MSCI China index (largely offshore) lost 10.22%.

There has historically been relatively low correlation between China A-shares and Global Emerging Market equities: Figure 4 shows a ten-year figure of 0.53. Yet investors should be cautious on this point: this correlation has increased over time, Q1 notwithstanding, with shorter-term analysis estimating correlation in the region of 0.7-0.8. Figure 4 also highlights the differentiation between onshore and offshore investing, with offshore stocks typically showing higher correlation with GEM equities.

There are a number of factors underpinning these results, including very different **sector exposures** in onshore and offshore markets, such as consumer staples largely listed onshore versus consumer discretionary offshore (see Figure 7). One particularly significant contributor, however, is **investor composition**: retail investors account for approximately 80% of trading volume in A-Shares, compared with 23% in H-Shares. Although the dominance of local retail investors in the onshore market is gradually decreasing, thanks in part to gradual index inclusion, this is likely to be a persistent feature of this market for the years to come.

FIGURE 4: TEN-YEAR CORRELATION BETWEEN CHINA A-SHARES, CHINA H-SHARES, GEM AND OTHER EQUITIES

	China A-shares	Offshore China stocks	Asia Pacific ex-Japan equities	Global Emerging Markets equities	Japan equities	US equities	European equities	World equities
China A-shares	1.00	0.68	0.55	0.53	0.39	0.43	0.40	0.45
Offshore China stocks	0.68	1.00	0.88	0.86	0.52	0.63	0.66	0.68
Asia Pacific ex-Japan equities	0.55	0.88	1.00	0.98	0.63	0.77	0.82	0.85
Global Emerging Markets equities	0.53	0.86	0.98	1.00	0.62	0.76	0.81	0.83
Japan equities	0.39	0.52	0.63	0.62	1.00	0.66	0.67	0.73
US equities	0.43	0.63	0.77	0.76	0.66	1.00	0.84	0.97
European equities	0.40	0.66	0.82	0.81	0.67	0.84	1.00	0.93
World equities	0.45	0.68	0.85	0.83	0.73	0.97	0.93	1.00

Source: bfinance, Bloomberg, calculated based on monthly data for the ten years to 31st May 2020. Indices: MSCI China A Onshore, MSCI China, MSCI AC Asia Pacific ex-Japan, MSCI EM, TOPIX, S&P 500, MSCI Europe, MSCI World

Why China? Why onshore? A brief recap continued

The strong presence of retail investors in China's onshore market also helps to explain active managers' outstanding alpha generation.

While managers in both onshore and offshore markets have typically beaten relevant MSCI indices, the outperformance in A-shares is particularly compelling (Figure 5). The average A-shares manager has delivered 5.5% per year over the last five years (to March 31st 2020) versus -6.2% for the index. In comparison, the average China equity manager (largely offshore, benchmarked against MSCI China) has delivered annualised returns of 5.3% versus 3.6% for the index. These strategies are discussed further in the next section.

A word on risk

While low institutional market share can create opportunity, it is also a source of risk, contributing at times to market volatility. Managers focused on company fundamentals can underperform in momentum-driven markets, with retail investors often trading based on news and social media. Domestic China asset managers are also a source of short-termism: their performance rankings are widely publicised, affecting flows from retail investors.

There are other key sources of risk when investing in Chinese equities. These include: fraud in companies' accounts, particularly where local auditors are involved; a very different legal and regulatory framework which can make it difficult to take legal action; the lack of effective hedging tools for A-shares; and, notably, geopolitical risks around the US-China relationship. On the final point, 2020 has already seen President Trump ordering the U.S. Federal Employee Retirement Fund not to invest its assets in Chinese companies.

FIGURE 5: PERFORMANCE OF ACTIVE CHINA EQUITY MANAGERS (ONSHORE AND OFFSHORE) VERSUS INDICES

Source: bfinance, eVestment, data as of 31st March 2020. All data gross of fees, in USD

Understanding the strategies

There is an increasingly broad and credible universe of actively managed China equity strategies across all major categories – offshore, onshore and now All-Shares.

This section reviews the four main strategies typically used by institutional investors to access Chinese stocks: Global Emerging Market (GEM), China A, China Equity (a long-established group predominantly focused on offshore securities) and All-Shares. It includes an extended commentary on All-Share strategies, given investors' rising interest in this somewhat newer approach.

Global Emerging Market Equities (including China)

There are now more than 200 asset managers offering over 400 active Global Emerging Market equity strategies. China exposure is highly variable depending on the strategy: most have 25-45% in China equities (roughly in line with the MSCI EM index), although a considerable number sit above and below this range. Many GEM equity managers do not have a local presence in mainland or Greater China.

Also in line with the MSCI EM index, we note that these exposures tend to be heavily **biased towards offshore equities**. Managers typically have a small number of analysts (three or fewer) dedicated to A-shares and many have only been in this market for a short period of time; some of these still lack appropriate models to screen A-shares effectively. As a result, GEM strategies will typically choose to cover only a few large cap China A-shares (<30).

A number of large asset managers that have both GEM strategies and dedicated China A-Shares and/or China All-Shares strategies; in these cases, the China team will often contribute ideas and insight to the GEM strategy and so A-shares may be more strongly represented.

A-Shares

This is now a well-established asset class featuring more than 60 managers, of which more than 40 have track records above 3 years. This group has also established their credentials in terms of alpha generation, as discussed in the previous section. They include a good selection of local boutiques as well as large asset managers although, as shown in Figure 6, local managers haven't necessarily outperformed their international counterparts; the latter tend to have offices in Hong Kong or Asia and typically employ Chinese (native or speaking) investment professionals.

FIGURE 6: LOCAL VS. INTERNATIONAL A-SHARES MANAGERS

	3 Years' Alpha (Annualised)			5 Years' Alpha (Annualised)		
	Min	Median	Max	Min	Median	Max
Local boutique managers	5.8%	11.4%	18.2%	7.5%	11.5%	16.4%
Large international managers	-0.1%	10.7%	21.5%	3.3%	11.0%	23.1%

Source: bfinance, eVestment, data as of 31st March 2020. All data gross of fees, in USD

Understanding the strategies continued

'China Equity' (aka managers with a predominantly offshore focus)

This is a very mature and established product set, which long pre-dated the opening up of Chinese onshore equity markets. There are in excess of 70 managers in this space and the vast majority have a track record of more than five years. Managers typically benchmark themselves against the MSCI China index, which has an increasing albeit still relatively low (10%) allocation to onshore equities.

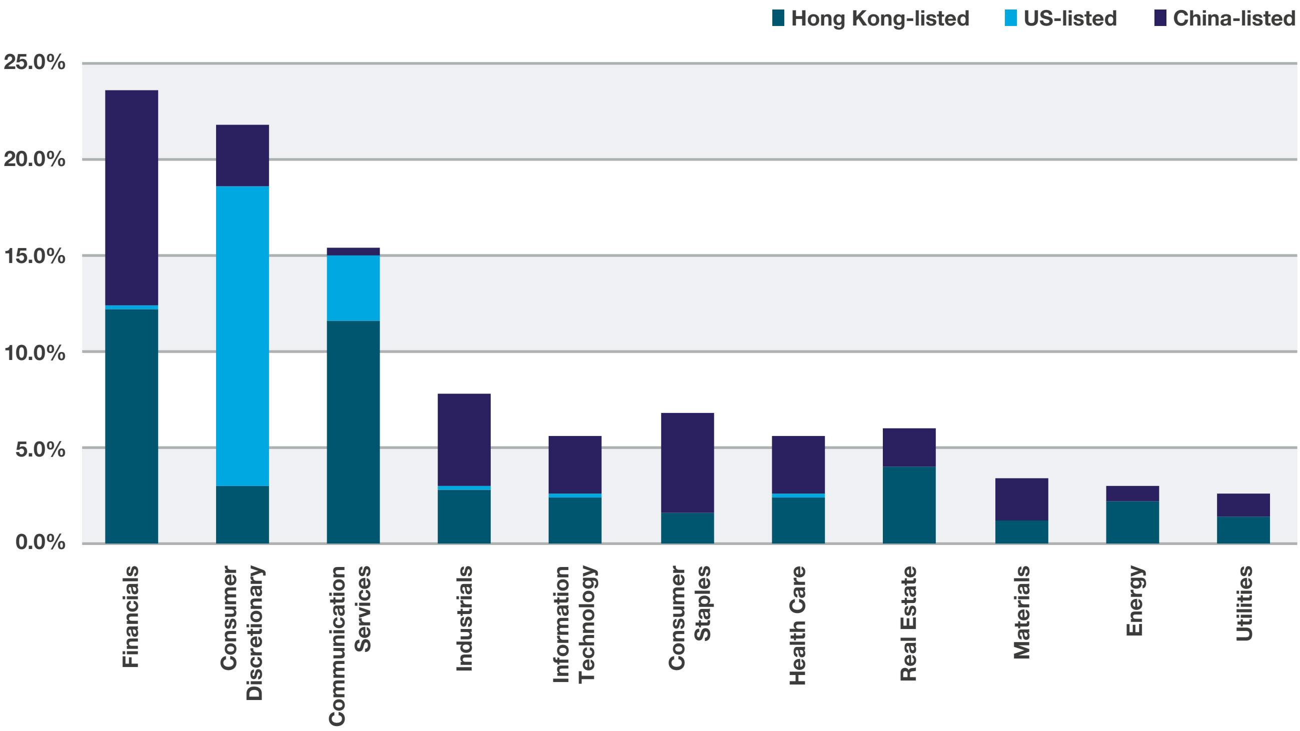
All-Shares

There are still fewer than 20 All-Shares strategies, many of which have short live track records in their current form. However, the actual number of viable All-Share strategies increases substantially upon closer examination. We are aware of ~25 further asset managers that do not currently have an All-Shares product but do have individual capabilities in onshore and offshore equities. These managers could – theoretically, at least – consider entering the space. In live manager searches conducted by bfinance we have identified more than 30 managers that either have an existing strategy or would be willing to launch one upon request.

Closer review also proves helpful when considering the typically short live track records. Many All-Shares managers have long-standing onshore and offshore products which can be extremely useful in assessing capability in the Chinese markets, including investment philosophy, investment process and stock selection skill. Therefore, while All-Shares strategies can be more than a combination of the two products (as discussed later in this section), the track records of those two products are extremely helpful.

In theory, All-Shares managers have the greatest **potential for alpha generation**. They have the widest opportunity set, spanning more than 3,500 A-Shares ($7.9 trillion of market cap) plus over 1,300 offshore listings for a combined $10 trillion market cap.

FIGURE 7: SECTOR EXPOSURES OF ADRS, H-SHARES AND A-SHARES



Source: bfinance, Bloomberg

Understanding the strategies continued

Stock selection in the onshore and offshore markets represents the most important source of alpha. In addition, All-Shares managers are also able to make relative value decisions between the different Chinese equity markets as a result of a more unified approach. These decisions can be at market level, sector level (with very different sector exposures in onshore versus offshore markets, as illustrated in Figure 7) or even at company level: 65 firms have a dual listing with both A-Shares and H-Shares. Evidence suggests that A-Shares are currently trading at a premium to H-Shares; an investor with separate strategies for the two segments cannot take advantage of such divergence.

It is also worth noting that the universe of nascent and potential All-Shares strategies opens the door to very attractive pricing. While China A-Shares managers typically charge management fees of 70-80bps and the more established All-Shares strategies charge roughly the same, clients that are willing to seed new strategies are able to obtain fees of 30-55bps or even lower.

A word on ESG

Historically, ESG considerations have represented a major challenge in Chinese equity markets. Corporate governance standards are generally weak and 2015 highlighted the risk of stock suspensions, which still represent an important concern for overseas investors. ESG integration in China has been complicated further by a lack of data, since major ESG ratings providers very low coverage of China prior to 2018 (<10% response in the case of MSCI).

Yet there has been substantial evolution on this point during the last two years. We now find that many managers have started to incorporate ESG into their process, either as a potential source of alpha or as a function of risk management. Index inclusion in 2018 has helped to drive a step change in terms of data availability: disclosure is improving, although companies are still relatively unfamiliar with this type of reporting. From 2020, all listed Chinese companies will be required to produce ESG reports.

ESG considerations are increasingly crucial to the majority of bfinance clients. We will be monitoring and reporting separately on managers' approaches to ESG integration in China's rapidly evolving equity markets.

Key takeaways

The majority of investors still obtain exposure to Chinese equities via Global Emerging Market equity strategies, which tend to have low exposure to onshore equities (A-Shares). Dedicated China strategies, particularly those with a strong onshore equity component, are becoming more popular.

There are now over 60 A-Shares strategies available, more than 40 of which have a track record of longer than three years. Investors may also be surprised by the quantity and quality of "All-Shares" offerings: we note over 30 managers that either have this strategy or willing and able to launch one based on existing onshore and offshore capability.

Active managers have demonstrated outstanding alpha generation. The average A-shares manager has delivered 5.5% per year over the last five years, versus -6.2% for the MSCI A-Shares index. In comparison, the average China equity manager (largely offshore) has delivered 5.3% per year versus 3.6% for the MSCI China index.

Recent publications available at **www.bfinance.com**

Manager Intelligence and Market Trends
(May 2020)

Sector in Brief: China A-Shares
(December 2018)

Investment Management Fees: Is Competition Working?
(October 2019)

IMPORTANT NOTICES

PROPRIETARY AND CONFIDENTIAL

This document contains confidential and proprietary information of bfinance and is intended for the exclusive use of the parties to whom it was provided by bfinance. Its content may not be modified, sold, or otherwise provided, in whole or in part, to any other person or entity without bfinance's prior written permission.

OPINIONS NOT GUARANTEES

The findings, ratings, and/or opinions expressed herein are the intellectual property of bfinance and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes, or capital markets discussed. Past performance does not guarantee future results. The value of investments can go down as well as up.

NOT INVESTMENT ADVICE

This report does not contain investment advice relating to your particular circumstances. No investment decision should be made based on the information contained herein without first obtaining appropriate professional advise and considering your own circumstances.

INFORMATION OBTAINED FROM THIRD PARTIES

Information contained herein has been obtained from a range of third-party sources, unless otherwise stated. While the information is believed to be reliable, bfinance has not sought to verify it independently. As such, bfinance makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential, or incidental damages) for any error, omission, or inaccuracy in the data supplied by any third party.

Office locations

Amsterdam
Symphony building-26th Floor
Gustav Mahlerplein 109-115
1082 MS Amsterdam
The Netherlands

T +31(0)20 794 61 00
www.bfinance.nl

Chicago
220 N. Green Street
Chicago IL 60607
USA

T +1 (312) 829-4353
www.bfinance.com

London
36 Queen Street
London
EC4R 1BN
England

T +44 20 7747 8600
www.bfinance.co.uk

Montréal
1250 René Lévesque Blvd. W
Suite 2200, Montréal QC
Canada H3B 4W8

T +1 514 393 4899
www.bfinance.ca

Munich
Promenadeplatz, 8
D-80333 München
Germany

T +49 89 55 29 59 00
www.bfinance.de

Paris
49, avenue d'léna
75116 Paris
France

T +33 1 45 02 64 00
www.bfinance.fr

Sydney
Level 8
99 Elizabeth Street
Sydney NSW 2000
Australia

T +61 2 8973 7503
www.bfinance.com

Toronto
88 Queens Quay West
Suite 2500, Toronto
Ontario M5J 0B8
Canada

T +1 (416) 560-7275
www.bfinance.ca

bfinance.com