Invesco Investment Insights

Fundamentally speaking: Active investing is key to capturing alpha in China A shares

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Key takeaways

- Active managers in China's A share market have shown that they can harness significant alpha despite market inefficiencies.
- A wide universe, significant dispersion and a rapidly-developing landscape offer many opportunities.
- Strong on-the-ground expertise sharpen active managers' ability to uncover valuable stocks.

Foreign interest in China's A share market, comprising shares of Chinese companies that trade on China's two main stock exchanges, has been increasing with their recent inclusion into global indices. As a result, there is more attention now on how investors can gain exposure to A shares while ensuring long-term outperformance in their portfolios.

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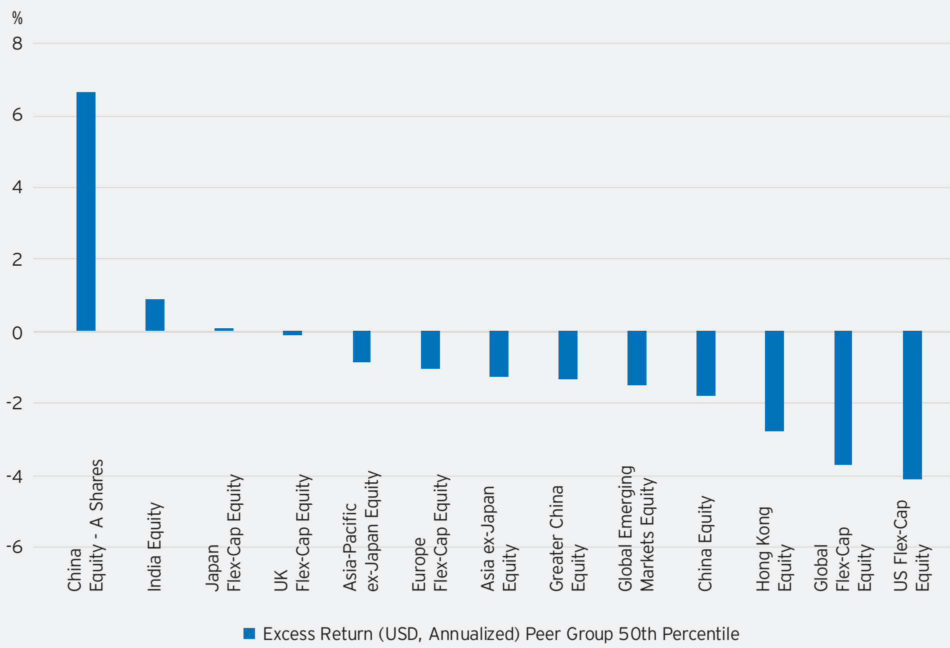
However, foreign investors are at the same time concerned about the availability of alpha, which can be attributed to manager skill in capturing risk-adjusted excess return net of fees, in the A share market. The market has many unique aspects, which make it difficult to achieve better returns through stock picking or market timing.

Chief among these concerns is the dominance of retail investors. They prefer quick capital gains and tend to allow news headlines dictate their investment sentiment, which all make the A share market susceptible to speculation, heightened volatility, sudden movements, and severe mispricing.

And yet, there is proof that active managers have shown their capability in capturing the significant alpha that's in the A share market (figure 1). Over the last five years, the median China A share active manager has outperformed the benchmark by 6.64%.[1] That's an outstanding performance even more so when compared to other global standards.

Figure 1: Median A share active manager can outperform benchmark by a big margin



Source: Morningstar, data taken from July 1, 2014 to June 30, 2019. Accessed on July 26, 2019.

Active managers have been able to capture alpha because inefficiencies in the A-share market offer many opportunities for them to do so. In particular, despite the seemingly irrational sentiment-driven gyrations of the A-share market, active managers have been able to prove that a fundamentals-based approach is an important way in generating alpha.

In this paper we explore what are the sources of alpha in China's A share market, and how a fundamental-based active-investing approach can capture alpha.

Alpha is hiding in plain sight in A share market

Diverse universe

The A share universe is vast and diverse with almost 4,000 stocks. Some represent the state-owned sectors that employ millions, while others are private-sector enterprises that are quick to serve consumers' needs. Some follow well-recognized business models, while others offer products and services that are more unusual or can be considered unique to China. Many of these stocks are not covered by analysts presently. These present countless opportunities for skilled stock pickers.

1. Data taken from Morningstar between July 1, 2014 to June 30, 2019. Accessed on July 26, 2019.

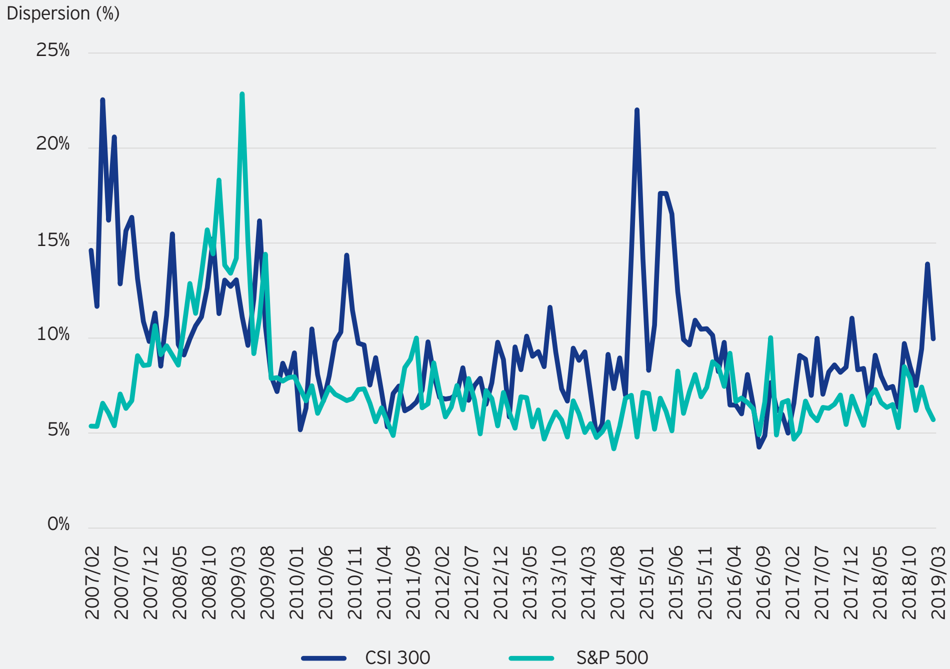
Undervaluation and high dispersion widen the alpha pool
At the same time, A shares are considered undervalued when compared to other markets. The market has been constantly beating market expectations (figure 2), and this undervaluation points to a deep pool of positive alphas to capture.

Figure 2: Benchmark A share index has been outpacing consensus growth

Source: Wind, Invesco Great Wall, as of June 13, 2019.

Similarly, there is a high rate of returns dispersion – often interpreted as a measure of the degree of uncertainty – and differences in stock valuations in the A share market (figure 3). A skilled active manager should know where he or she can target to uncover sources of diversified alpha to add to performance.

Figure 3: China A shares have deviated more from benchmark than US large caps



Source: Wind, Invesco Great Wall, data as of March 31, 2019.

Fledging market offers attractive opportunities
Even though the fledging market is getting more sophisticated day by day, progress has been gradual.

A government pilot program that started in late 2017 to transfer shares in state-owned firms to the national pension fund[2] would give institutional investors a stronger presence in the market. There have also been new regulations aimed at strengthening the asset-management, insurance and banking sectors.

However, many of the onshore institutional investors are still constrained by short-term goals. They also do not have much access to foreign investment channels. Large, long-term focused investors such as pension funds are also still developing, as evidenced by the slow transfer of state-owned enterprises' equity to the national pension fund.[3]

We believe that the measured pace of institutionalization benefits skilled active managers. They can harvest more alpha before more competition crowds the scene.

Also, China's rapid pace of development means that there are often sectors and business models that emerge. As policymakers catch up to regulate these new industries or firms, active managers that stay ahead will know how to price these opportunities more accurately.

Our analysis on fundamentals-based approach in China A shares

Through our research, we have found that active managers have shown that they have been able to overcome those inefficiencies using a fundamentals-based approach to generate substantial alpha over the years.

In coming to this conclusion, we did our own analysis. We looked at earnings yield (EP ratio) and earnings per share (EPS) – both common metrics used to look at a company's fundamentals – of constituents of the benchmark A-share index CSI 300.

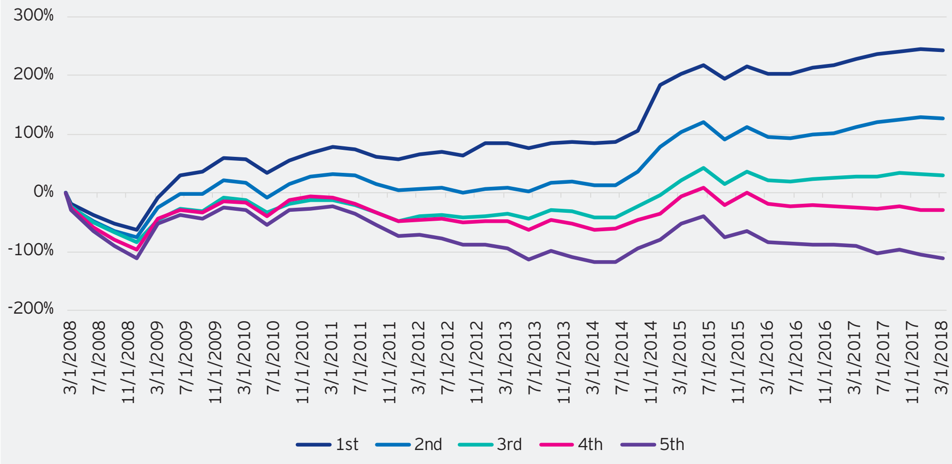
We think that basing them on the securities' forward 12-months' earnings would be a good reference, because hypothetically, if an investor knows what the earnings for each company will be in the next 12 months, the investor should select stocks based on the best forward 12-months earnings to current price ratio. We would be interested to see how much the portfolio would return in 12 months' time to determine if fundamentals-based active investing works in China A shares.

In our analysis, we collect our results on a quarterly basis and divided them into quintiles ranging from the highest- to the lowest-performing stock. Then, at the end of each quarter over our time horizon (from Dec 31, 2007 to March 31, 2018), we recalculate the metrics and rank the universe accordingly.

The results were telling. For EP ratio (figure 4), the top quintile has been able to achieve a 20.2% annualized excess return, while for EPS change over price (figure 5), the top quintile generated 21.1% annualized excess return. What's also important is that the each quintile changed by about the same degree, further reinforcing the notion that focusing on fundamentals can reveal trends in share performance.

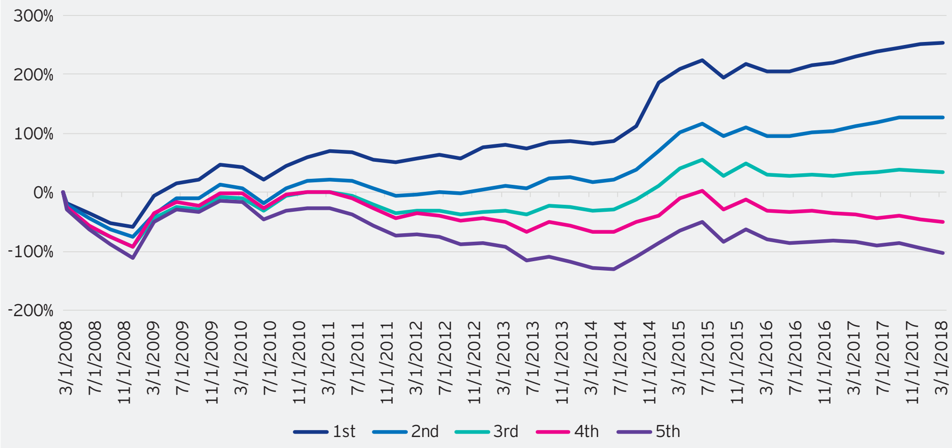
2. "China to transfer state assets to pension fund in bid to boost shortfall", Reuters, published Nov. 18, 2017.
3. "Exclusive: China's Social Security Fund Chief Lou Jiwei Retires", Caixin Global, published March 26, 2019, accessed on June 4, 2019.

Figure 4: Earnings yield of top quintile in CSI 300 has outperformed over time



Source: Wind, Invesco Great Wall, data as of March 31, 2018.

Figure 5: EPS change over price of top quintile in CSI 300 has outperformed over time



Source: Wind, Invesco Great Wall, data as of March 31, 2018.

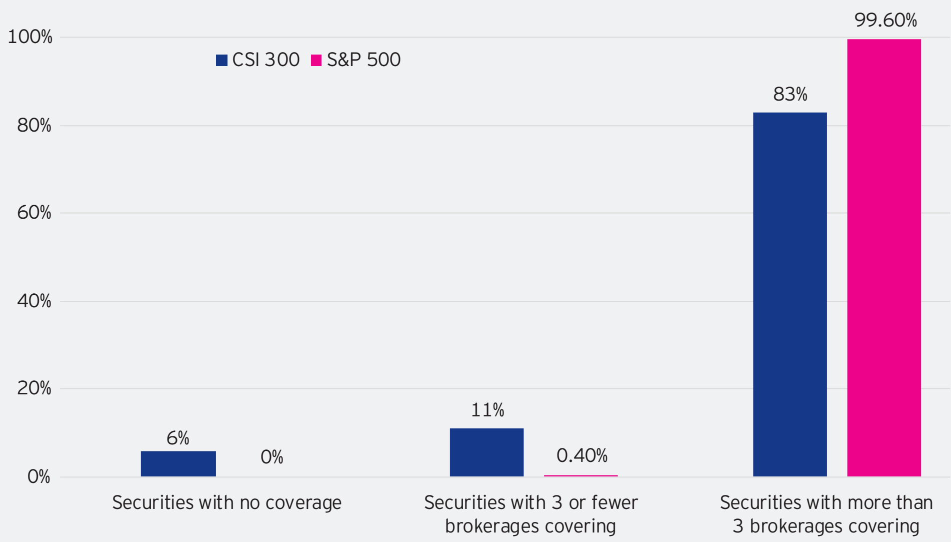
How active investing can harvest alpha in A shares

There are a few ways that active managers can take to generate more alpha through A share investing.

Searching further
A general approach is to widen their search for quality names to add to excess returns. In the past when the A share market was more inaccessible, a narrow allocation to Chinese blue-chip names was good enough for investors to capture alpha.

But now, with increased foreign interest and better access, active managers must widen the hunting ground and intensify the search. For the A share market, there's still quite a bit to uncover with about 6% of securities receiving no coverage, 9% with only three or fewer analysts covering (figure 6). For the S&P 500, the respective numbers are at 0% and 0.4%.

Figure 6: Still a lot to uncover in China A shares



Source: Wind, FactSet, Barra, Bloomberg, as of May 31, 2019.

Overcoming biases
Another approach would be to look at the benchmarks' inherent biases and try to seek out valuable names that can help their portfolios overcome those limitations. We think that global indices tend to overlook small- to mid-cap stocks in A shares. As for the CSI 300, a capitalization-weighted stock market index tracking the performance of top 300 stocks traded in the Shanghai and Shenzhen stock exchanges, we see that it is still undergoing structural changes to give more representation to the new economy (stocks that belong to the consumer discretionary, consumer staples and information technology sectors). Smaller companies and consumer trends can be good alpha generators. Skilled investment teams can exploit these to their benefit.

Good governance
A focus on corporate governance can also generate more alpha. In China, corporate governance issues such as financial reporting, disclosures, and accounting standards are not high on many companies' radar. These issues obscure where potential alpha may lie within the A share market.

Diligent active managers that establish good rapport with investee companies should get a better picture of how a company is expected to perform. They can also unearth companies with good practices that will likely keep them out of regulators' crosshairs. We believe that having in place a robust set of due diligence processes will help managers uncover more attractive names to invest in, thus generating alpha.

Overall, there's a common theme that run through all these approaches – active managers that have strong expertise on the ground will be able to uncover valuable companies that are likely to add strong alpha to returns.

What are the risks?

However, there are still some uncertainties when pursuing a fundamental-based active investing approach to China A shares. There are the usual risks of investing in emerging markets like China. We also note that there are other unique challenges that investors may face when looking at Chinese markets.

Policy uncertainty
Policies and regulations may change fast or suddenly as China reforms and liberalizes its financial markets. For example, recent clampdowns on shadow banks, gaming companies, drug-makers and even kindergartens have put immense downward pressure on the share performances of listed companies in these sectors. Also, initiatives such as Stock Connect and Qualified Foreign Institutional Investor (QFII) – main channels through which foreign investors invest in China A shares – are still new and may see further tweaking to how they operate.

Stock suspension
Listed companies also are allowed to suspend trading of their own shares, and companies have been known to do so on a very weak pretext. Sometimes, suspensions can go on for months. The Chinese Securities Regulatory Commission in November 2018 had introduced a series of guidelines geared towards improving the situation. We view this as a positive step as China looks to institutionalize the A share market even more, and to attract more foreign investors to the market.

Conclusion

For now, the A share market is still keeping on its track towards a higher level of sophistication, albeit at a slow and measured pace. This gradual transition from being retail-led towards more institutionalization is a good window of opportunity for skilled managers to capture strong alpha with greater ease than before. This means that investors and fund managers that are early movers and have experience on the ground can find attractive names to uncover in China's A share market.

But we stress that even though a fundamental-based approach can help savvy stock pickers to outperform competitors, its true value lies in its long-term prospects: the A share market will continue to evolve and mature. This means that ultimately, it is the active managers that have the acumen, skills, resources and deep on-the-ground expertise that will be able to constantly uncover the true value of A share names. This way, they can uncover ample opportunities to generate good active performance.

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