Invesco Investment Insights

Taking the "A" out from "EM": Making sense of a dedicated China A share exposure

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Key takeaways

- China's growing economic clout and weighting in global equity benchmarks will affect portfolio allocations.
- China's A share market's growth drivers and structure are different from other emerging markets.
- Having a dedicated A share exposure gives investors the full access to the rewards and risk the market presents.

China's growing economic clout and dynamism has benefited its companies and they present attractive options for investors looking to tap into China's growth potential. In a nod to their importance, global equity index providers are increasing Chinese companies' onshore-listed shares, known as A shares, representation in their benchmarks.

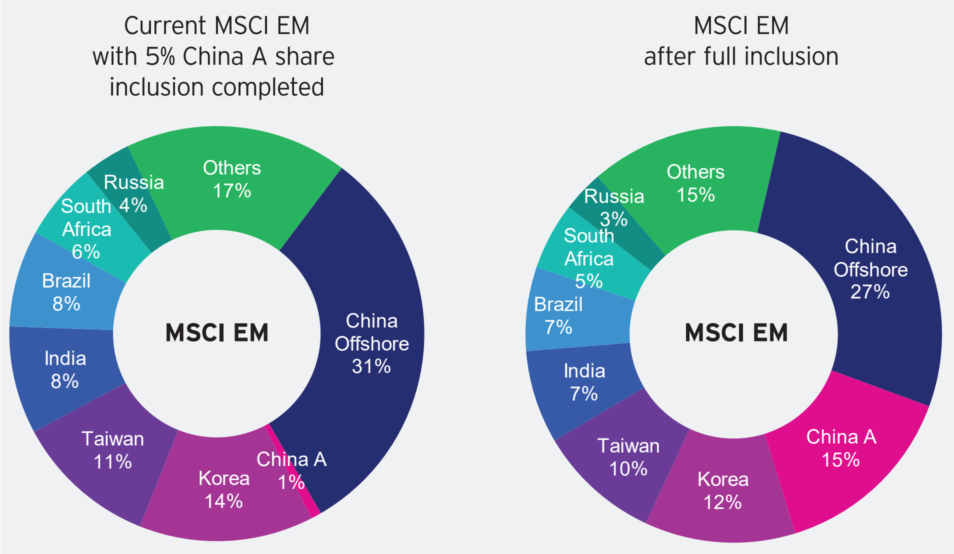
These developments will no doubt affect allocations in global portfolios. Presently, global investors are likely to have most of their China exposure via Chinese companies' stocks listed in Hong Kong or the US. They now must think about how they should allocate to China A shares to fully capture the risks and reward that these onshore-listed stocks present. Some investors are even wondering if they should have dedicated exposure to China A shares, rather than having it as part of a global or emerging-markets portfolio.

In this paper, we look at how investors should think about their exposure to China A shares and argue that a dedicated allocation to the asset class makes for a very compelling approach for global investors.

A shares gaining more foreign interest but still under-represented

Global index providers are certainly taking notice of China A shares' attractiveness. MSCI in May 2019 started to increase the weighting of China A shares in its emerging-market benchmark from 5% to 20% gradually. While the timeline for full inclusion hasn't been revealed, a 100% inclusion would mean A shares would make up about 15% of the MSCI Emerging Markets (EM) index (figure 1).[1]

Figure 1: Full inclusion increases weighting of China A shares in MSCI EM index



Source: MSCI, Citi research, March 2019.

Elsewhere, FTSE Russell in June 2019 started a nine-month implementation of adding the asset class to the FTSE Global Equity Index Series as a secondary emerging market. Some 25% of the investable market capitalization of eligible names will be included.

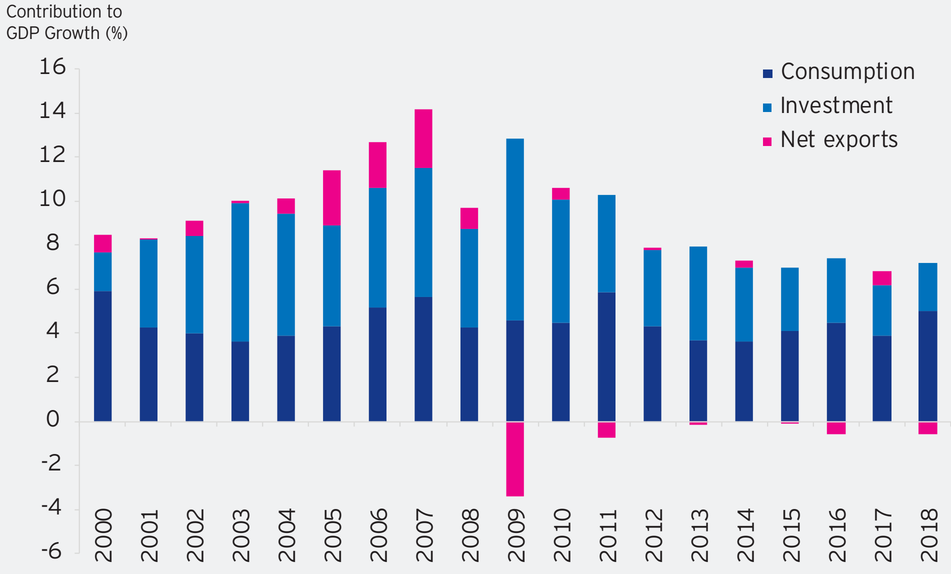
China's capital-market reforms in opening up its equity markets were a major reason why the global index providers were willing to include A shares into their benchmarks. However, we think that this still under-represents the asset class's clout on several fronts.

China is not like other emerging markets
China may be classified as an emerging market, but the classification is made up of diverse economies. China stands out among them on several counts. In absolute terms, China is the world's largest economy based on purchasing-power parity at $25.27 trillion in 2018, even though it's still classified as an emerging market.[2] It is on track to eliminate absolute poverty by 2020, according to China's current poverty standard (per capita rural net income of RMB 2,300 per year in 2010 constant prices).[3]

1. MSCI, Citi research, March 2019.
2. International Monetary Fund database April 2019.
3. The World Bank in China - Overview, World Bank website, accessed on July 5, 2019.

More importantly, drivers behind China's real economic growth are different from other major emerging-market economies, with domestic consumption accounting for 76.2% of GDP growth in 2018 (figure 2).[4] In comparison, other key emerging-market economies are more exposed to global trends: South Korea and Taiwan depend on exports for economic growth, while commodities drive the economic growth of South Africa, Brazil and Russia rely on commodities. All these mean that China's economic, business and monetary cycles are less in sync with global ones.

Figure 2: Domestic consumption's contribution to China's GDP is increasing



Source: Wind, as at July 31, 2019.

China's equity market stands out from other emerging markets'

From the equity market's point of view, China's A share market offers a very different risk profile, or beta, than other markets.

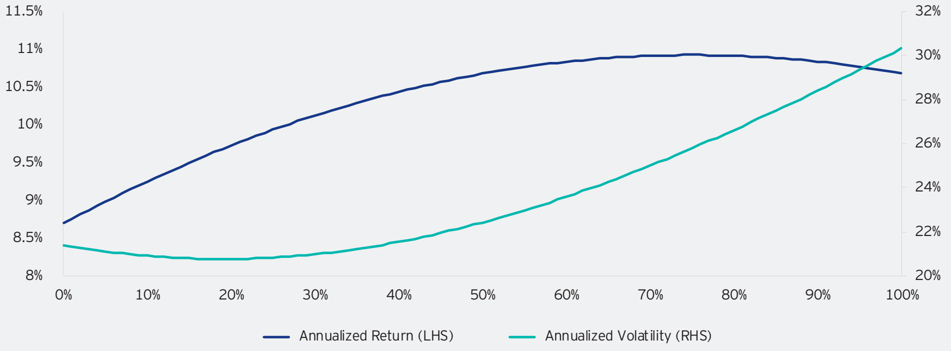
Domestic focus
The A share market's domestic focus is a key factor contributing to its beta. Participants in the A share market have a unique profile: investors are overwhelmingly domestic retail individuals, while the companies that issue A shares derive most of their revenues from the domestic market.

Due to the consumption-driven nature of China's economic growth, most A share investors and listed companies are more likely affected by domestic concerns rather than external considerations. The domestic focus and dominance of retail investors also mean that the A share market is highly sensitive to policy and regulatory shifts.

All these mean that the A share market has a tendency to be volatile. It also means that it marches to its own beat. However, we think that this unique aspect of China's A share market is its biggest strength. Its low correlation to other equity markets in emerging markets – or even among Chinese share classes – helps in diversification (figures 3 and 4).

4. National Bureau of Statistics of China, accessed on July 3, 2019.

Figure 3: Increased A share allocation in MSCI EM ex-China A shares portfolio has improved returns noticeably



Source: FactSet, as of June 28, 2019. Data was sourced from July 2004 to June 2019 on a monthly basis.

Figure 4: Correlation of A shares with various indices (July 2009 to June 2019)

	CSI 300	MSCI China H	MSCI AC Asia Pacific ex JP	MSCI EM (Emerging Markets)	MSCI Japan	MSCI USA	MSCI AC European	MSCI AC World
CSI 300	1.00	0.73	0.54	0.53	0.34	0.43	0.39	0.46
MSCI China H	0.73	1.00	0.84	0.83	0.47	0.62	0.62	0.70
MSCI AC Asia Pacific ex JP	0.54	0.84	1.00	0.98	0.61	0.78	0.82	0.89
MSCI EM (Emerging Markets)	0.53	0.83	0.98	1.00	0.59	0.76	0.81	0.87
MSCI Japan	0.34	0.47	0.61	0.59	1.00	0.66	0.66	0.72
MSCI USA	0.43	0.62	0.78	0.76	0.66	1.00	0.84	0.96
MSCI AC European	0.39	0.62	0.82	0.81	0.66	0.84	1.00	0.94
MSCI AC World	0.46	0.70	0.89	0.87	0.72	0.96	0.94	1.00

Source: Bloomberg, FactSet, data as of June 30, 2019.

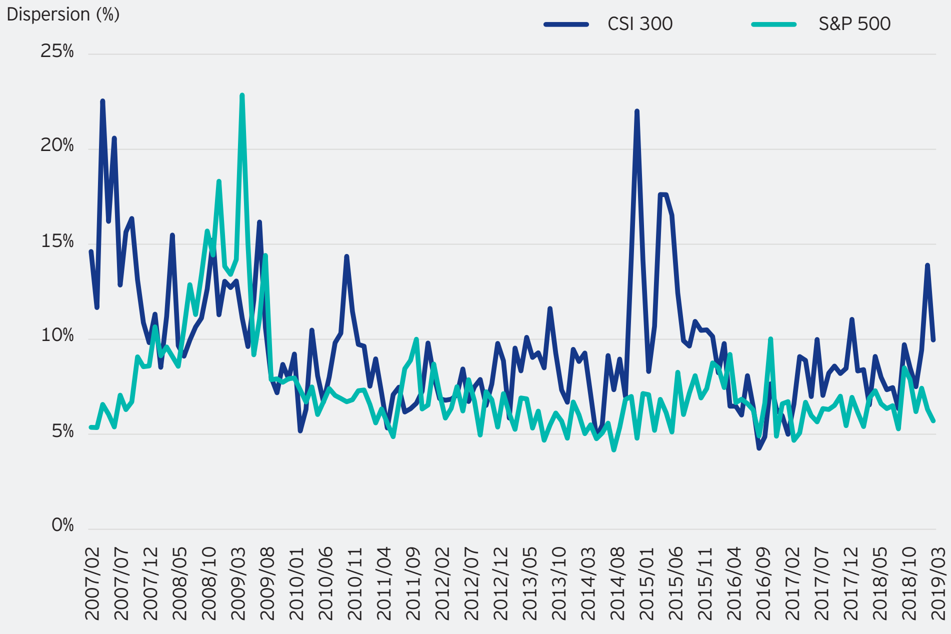
Sheer size

The A share market is also known for its sheer size. With almost 4,000 securities, it is huge and very diverse both in terms of industry and individual stock level. Some of these exposures are also unavailable in offshore Chinese equities such as H shares and American depository receipts. For example, A shares allow investors to gain exposure to smaller companies and sectors such as Chinese pharmaceuticals (traditional medicine) or spirits. It would be difficult to cover A shares with just a handful of holdings in a global emerging markets portfolio. Similarly, traditional global benchmarks tend to have a large-or mid-cap bias. Therefore, having a direct allocation to A shares would be more appropriate to capture the opportunities within this universe.

High dispersion

The A share market has a high rate of returns dispersion (figure 5) – often interpreted as a measure of the degree of uncertainty – and differences in stock valuations. This also occurs at the sectoral level. A dedicated, skilled active manager should know where he or she can target to uncover sources of diversified alpha to add to performance.

Figure 5: China A shares have deviated more from benchmark than US large caps



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

Dynamic economy
China's private sector is very fluid, made up of industries and companies that are very dynamic and a fast-changing competitive landscape. To accurately capture the alpha and manage risk in A shares requires devoted attention from active managers.

Concerns over dedicated allocations to A shares

Investors should also be aware of the risks and problems that may result from having a dedicated allocation to China A shares.

Risk management
We've talked about the idiosyncratic risks that China A shares can represent. In a global emerging markets portfolio, a generalized risk model is applied across the board, and if China A shares are put into this same portfolio, a lot of these idiosyncratic factors will get buried and be overlooked. If A shares are behaving differently from other asset classes, investors won't be able to find out why within the global emerging markets portfolio.

Policy and regulatory risks are another major concern. The country is still opening itself up to foreign investments while ensuring stable economic growth and currency strength. This means that despite China gradually easing capital controls, the flow of capital still remains heavily regulated. Not only does that impact how much funds can investors repatriate, they can also result in volatility when investors expect a downturn in the near term.

These distinctive risks that China A shares present require a concerted effort at managing them, which would entail a targeted, standalone strategy to achieve the best results possible.

We stress that while a dedicated allocation to China A shares doesn't mean that risks would be lower, the approach would make the idiosyncratic risks more visible, allowing active managers to afford it the necessary attention.

Governance concerns
The low quality of corporate disclosures, governance, and accounting standards are another source of worry that could make an investor think twice about allocating directly to A shares. However, we stress that these issues are not unique to China alone – many emerging markets also face the same problems. In fact, China has been taking steps to improve on these fronts. Though these issues remain a risk for investors, skilled active managers can help them mitigate these dangers.

Implementation worries
There may be concerns over implementation. Investors that typically do not take on single-country mandates may find a dedicated China A shares allocation difficult to implement. At the same time, the lack of global ex-China indices means that those who choose to have an A share-specific allocation may see some overlap with other allocations. However, we see this as teething problems that can be resolved as time goes by. We expect more and more investors are likely to see the value of China A shares and will want to make dedicated allocations to them.

Conclusion

We've shown how a dedicated exposure to China A shares can help investors manage the idiosyncratic risks and reward that the asset class offers. An added benefit that arises from the standalone exposure, then, is the ability to capture higher alpha.

It's worth noting that many of these benefits from having a dedicated allocation to China A shares are temporary — we think that they will weaken over the next five to 10 years. As their representation on global indices increases and as China allows more foreign money to flow into its stock markets, the correlation benefit will fade, and the market will become more efficient. Considerations in capturing alpha will subsequently change.

For now, despite the uptick in global interest, the market remains largely driven by retail investors. At the same time, macroeconomic and global uncertainty about China's progress is sidelining a lot of investors. As China's clout grows within the emerging-market pool, long-term investors who are early movers are more likely reap the full benefits from a dedicated China A share exposure.

Investment risks
The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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