# How to Capitalize on a Bright Outlook for Chinese Equities

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**As China A-shares enter the major MSCI indices — a significant milestone on China's journey towards becoming an advanced economy through reform and opening up — we think now is a good time to review the case for investing there and how investors might implement their allocations.**

**In our view, the long-term investment case for China remains strong, and with this latest development, investors should consider an investment approach that combines both onshore and offshore Chinese equities into a unified, standalone China mandate.**

## Key Points

- The long-term investment case for China remains robust while the Chinese government continues along the path of reform and promotes domestic consumption
- More accessible onshore Chinese markets mean investors may want to consider running a unified China equity strategy with different types of shares in a single portfolio
- China's differentiating attributes make it a good candidate for a standalone allocation rather than as part of a broader Emerging Markets strategy

## THE CASE FOR INVESTING IN CHINA

We have long been positive on China in the belief that economic liberalization would help drive and sustain rapid growth, which in turn should help quality companies grow their businesses and deliver strong returns. We think the fact that offshore Chinese equities have been among the top performers outside the US since 2003 attests to the validity of this belief and that this outstanding performance is the direct result of China's efforts to transform their economy, thereby creating a favorable economic backdrop for Chinese corporate growth.

Over the last 15 years, the MSCI China Index has outperformed the broader MSCI Emerging Markets (EM) Index by over 4% per annum, and outperformed MSCI World (developed markets) by over 7%. These annual differences compounded over 15 years result in a massive overall divergence in returns (see Figure 1). This is even more remarkable as China is a large component of the MSCI Emerging Markets Index. EM outperformance in recent years has been largely a China story.

We believe there are compelling reasons for this to continue. First, the leadership's commitments to further reform and opening up should ensure that China remains one of the fastest growing major economies for years to come. Second, China's equity markets are broad and deep and now almost fully available to global investors, who are currently underweight and likely to add exposure as China A-shares grow as a share of the major indices like MSCI. Skilled active managers, meanwhile, can continue to find plenty of alpha opportunities as Chinese equity markets remain fairly inefficient compared to developed markets.

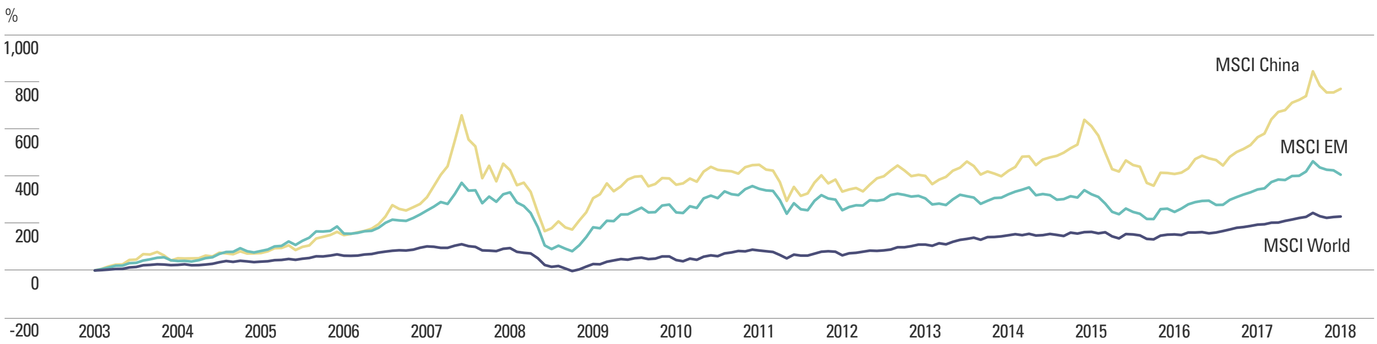
### Strong Economic Growth Likely to Continue

While China's GDP growth has decelerated over the past 10 years to 6.8% in 2017, it remains well above that of other economies, accounting for about 27% of global growth last year. In our view, while growth may slow from here, China should be able to maintain above-average economic expansion for many years to come.

This is because it still has a lot of catching up to do. Its per capita GDP is low relative to that of developed economies (Figure 2) and economic and market reforms are incomplete. As efforts continue to close the gap, these should help attract investment, increase efficiency and boost productivity.

Moreover, the Chinese economy has undergone significant positive structural changes, in particular, shifting from a largely agrarian society to a manufacturing powerhouse, and, in recent years, towards services. This is reflected by labor employment trends. While labor employed in primary

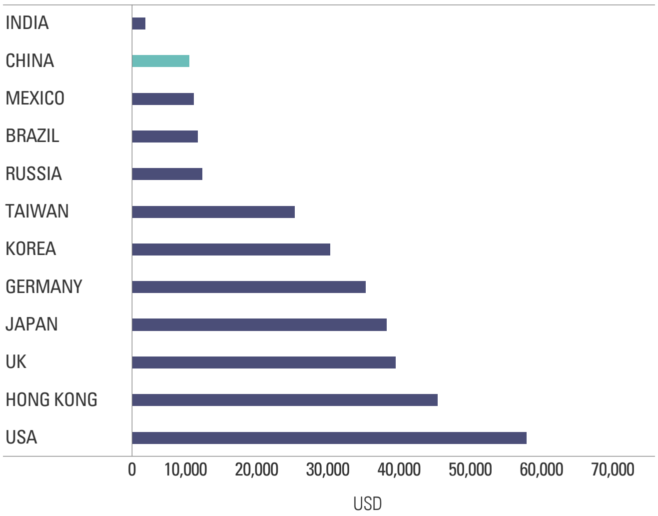
**Figure 1: Cumulative Total Return Over Last 15 Years through May 31, 2018 (in USD)**




Source: MSCI, State Street Global Advisors as of May 31, 2018.

Past performance is not a guarantee of future results. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

**Figure 2: China's per Capita GDP is Still Relatively Low**




Source: IMF as of December 31, 2017.

industry (mostly agriculture) has declined from 47% to 27% of the total since 2004, labor employed in tertiary industry (services) has increased from 31% to 45%, leading to greater urbanization and labor productivity. There has also been a move from investment-led growth fueled by credit towards more sustainable consumption-driven growth.

## Potential Risks to Our View

Two frequently raised concerns about China are its debt levels and, more recently, the potential for a trade war with the US. While these are causes for legitimate concern, our view is that, as things stand, neither should disrupt China's long-term economic growth trajectory.

On debt, we would agree that China's economic growth has been fueled in part by increasing debt leverage and that the aggregate debt level relative to its GDP is high by global standards. We believe, however, that China's debt is manageable; China has a high domestic savings rate and much of the debt is financed locally. As Japan has shown, with mostly local financing, higher debt levels can be sustained.

Moreover, policymakers in China have taken steps to tackle the issue under a so-called "de-leveraging" initiative. This appears to be having an effect. Overall debt to GDP levels as well as non-performing loan ratios have plateaued recently. Finally, something that is often missed in this debate is that this debt can be set against government assets. These include land ownership, company holdings and large foreign reserves. As a result, "net" debt is a lot lower than the "gross" debt many focus on. Finally, having a centrally controlled government, China has a range of unique tools to stem a potential debt crisis.

As for trade wars, the risks are significant but short-term, in our view. So far, the size of the threatened tariffs is small relative to the size of the economies affected. President Trump may try to escalate tensions further in an attempt to encourage his base before the mid-term elections. But we think it is unlikely that American voters would support a full-blown trade war that causes significant pain for US businesses and consumers. Our view is that eventually cooler heads will prevail and compromises will be reached, though perhaps not without some short-term instability which could temporarily weigh on sentiment. But as long as the Chinese leadership maintains its commitment to continuing reform, our long-term positive investment thesis should remain intact.

## BUILDING YOUR CHINA EQUITY EXPOSURE

### Broad, Deep and Open Equity Markets

There are several areas to consider when building a Chinese equity portfolio. The first is diversification. Unlike those of many emerging economies, China's equity markets are broad and deep. The Chinese onshore and offshore stock markets combined have over 4,000 listed companies with a total market cap of over $10 trillion. The number of securities in the MSCI China Index has expanded recently from 153 to 447, of which more than 200 are A-share names. The index includes well-known internet giants like Alibaba and Tencent, leading local consumer brands like Moutai and globally competitive appliance makers like Midea.

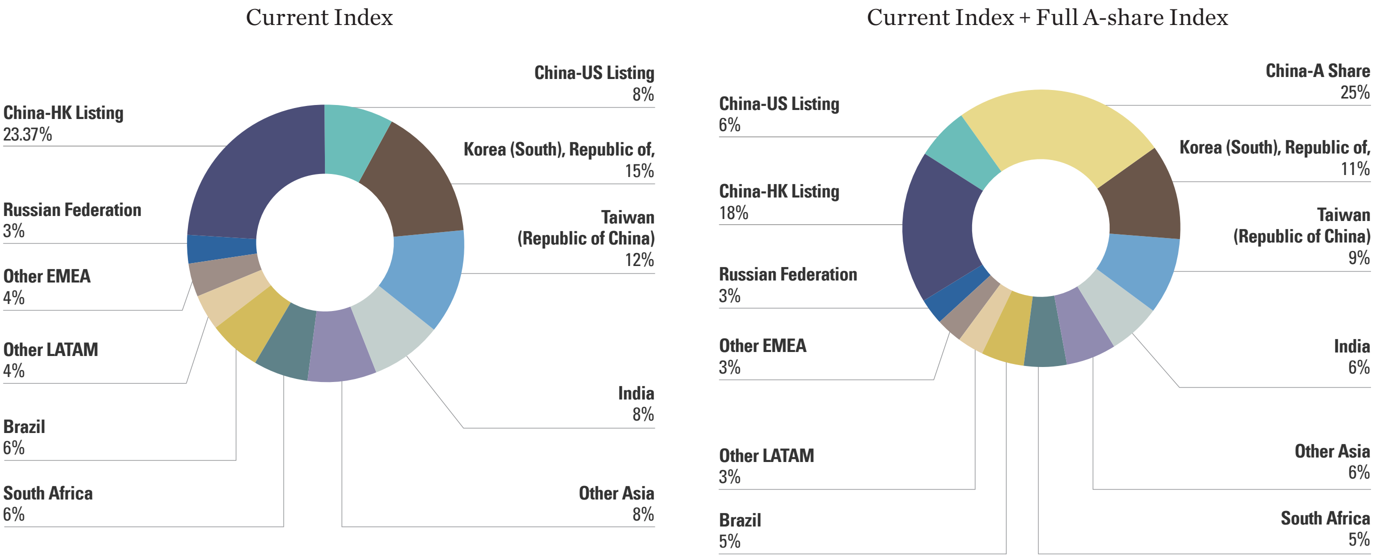
Previously, most overseas investors were limited to investing in shares listed outside of mainland China. Now that the onshore China A-share market is accessible via the Hong Kong Connect programs, asset managers should be able to build more robust China portfolios with better risk-adjusted return potential. As a result, we expect to see increased global institutional participation, which should help promote a stronger equity culture in China with better corporate governance, greater transparency and more shareholder-friendly policies.

### "Topping Up" Underweight China Exposure

Nonetheless, China still has far to go to reach what we view as its true representative weight in global investors' portfolios. Due to a 5% inclusion factor used at this stage by MSCI, A-share weights in major MSCI indices are still significantly below what the A-share market cap would call for. If MSCI were to include the full MSCI A-Share Index, China's weight in the MSCI EM Index would jump from about 33% today to 49%, as shown in Figure 3. In GDP terms, China's weight among emerging markets is 43%, well above its EM Index weight.

If investors' sole China exposure comes via broader emerging markets or global equity allocations, they are likely to be underweight China — a gap that is only likely to grow as China advances. In which case, it may be worth considering "topping up" their exposure with an allocation to a dedicated China equity mandate. Given China's significance to the global economy and the aspects of China that differentiate it from other EM countries, we believe that over time, investors will increasingly come to view China as its own allocation.

**Figure 3: China's Current Weight in the MSCI Emerging Markets Index and Plus the Full MSCI A-Share Index**




Source: MSCI, State Street Global Advisors as of May 31, 2018.

## Unifying China Equity Strategies

Chinese equities have an array of different share categories, but the main distinction has been between offshore, which have been open to foreign investors, and onshore traded A-shares, which have been more difficult for investors outside of China to access. Because of this difference in accessibility, investors, if they invested at all, treated A-shares as a separate allocation.

Our Fundamental Equity team launched its dedicated China Equity (offshore) strategy in 2002 and its dedicated China A-share (onshore) strategy in 2007 under the QFII (Qualified Foreign Institutional Investor) program. For many years, we had separate offshore and onshore China equity strategies to gain China exposure, not because we favored this approach, but out of necessity. Due to China's very strict capital controls and the many restrictions on QFII, it was not practical to run a unified China strategy.

Today, however, things have changed. The Stock Connect program has greatly opened up the once closed A-share market to global investors. At the same time, China has also substantially liberalized its QFII and RQFII (Renminbi-QFII) programs and lifted many of its original restrictions.

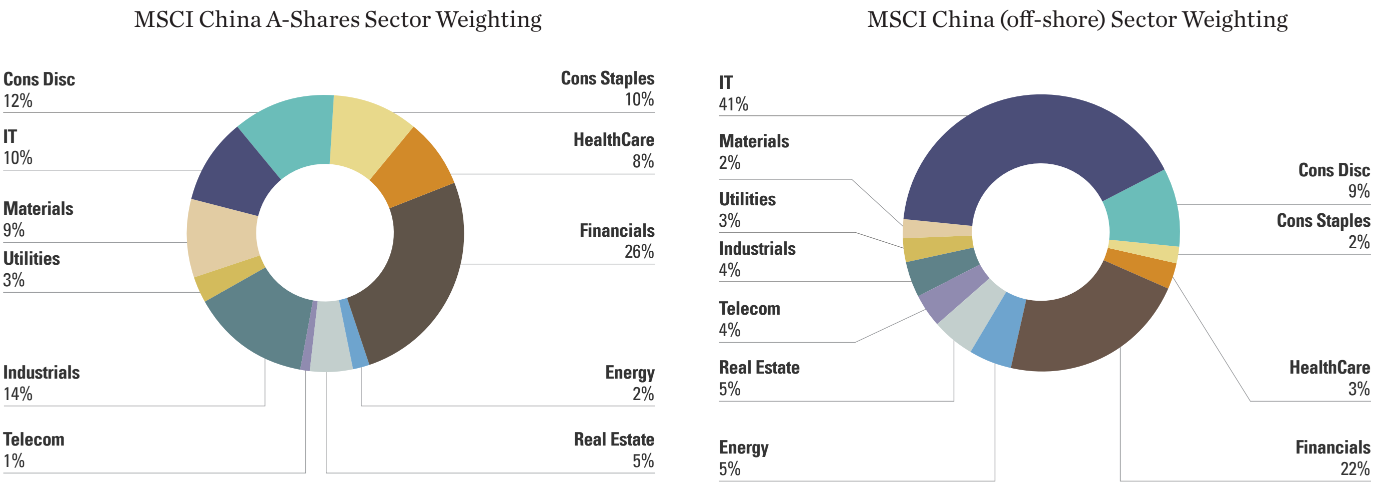
In our view, with the advent of the Connect program and inclusion of A-shares in MSCI indices, the distinction between onshore and offshore China equity markets is no longer relevant. It is now feasible for global investors to run a unified all-share China equity strategy, enabling their holdings to be optimally managed in one integrated portfolio.

We believe this is a better approach and have evolved our State Street Global Advisors China Equity strategy into a unified China equity offering. At a fundamental level, all types of Chinese shares are the same and subject to the same macroeconomic conditions. A unified China equity strategy offers full flexibility to invest across the China equity universe, which should enable more efficient alpha capture and better returns. The onshore/offshore mix in the portfolio becomes an outcome of the team's bottom-up stock selection process.

## More Quality Companies Listed Offshore

While we favor a unified China strategy and see opportunities among select A-shares, we think a disproportionate number of higher quality and investable Chinese companies are listed offshore. We have attributed this phenomenon to two factors: (1) differences in company listing processes and criteria between onshore and offshore stock exchanges and (2) the strong preference for offshore listings by foreign VC investors who have backed many of the most successful start-ups in more dynamic sectors of the economy. This also explains the differences in sector exposures between the onshore and offshore Chinese equity universes (see Figure 4), which has significant investment implications.

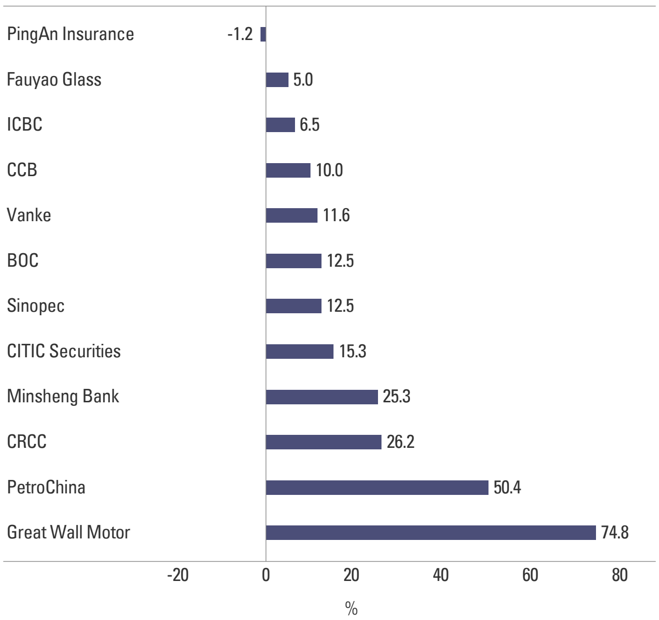
**Figure 4: China Offshore Index Better Represents New Economy**




Source: MSCI, State Street Global Advisors as of May 31, 2018.

Valuations differences between onshore and offshore markets can also be very large, even for dual-listed companies. Currently, most A-shares are still trading at significant premiums above those listed in Hong Kong (see Figure 5). As a result, we would caution against an A-share only China strategy, as we think the relative underperformance of the overall A-share market in recent years could continue. Instead, we would opt for a unified strategy with a preference currently for offshore stocks. Over time, this is likely to evolve as the opportunity set across the difference exchanges alters.

**Figure 5: China A-shares Premium/Discount to H-shares**




Source: Bloomberg, State Street Global Advisors as of May 31, 2018.

## CONCLUSION

China's transformation has been one of the great global investment themes of our time, and, in our view, it still has a long way to go. Our long-term positive view on China equity is anchored by our belief that China's continued pursuit of reform and opening up will help sustain healthy economic growth for years to come.

Given the economic and market developments already underway, we recommend a dedicated China equity allocation as China is fast outgrowing its EM status. We believe a unified China equity strategy is the best approach to gain broad and diversified Chinese equity exposure, while ensuring the portfolio is not overexposed to A-shares, which we believe will continue to underperform.

### Glossary

**MSCI China A Index** An index designed to track large and mid-cap equities listed on the Shanghai and Shenzhen exchanges.

**MSCI China Index** An index designed to track large and mid-cap equities across China H shares, A shares, B shares, Red chips, P chips and foreign listings.

**MSCI Emerging Markets (EM) Index** A free float-adjusted market capitalization index designed to measure equity market performance in 24 global emerging market economies.

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