Insight
Market Outlooks

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Key Considerations for Investment in China Equities

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- The sheer size, growth trajectory, and speed of change of China's equity market distinguish it from other emerging markets.
- Taking full advantage of the China growth story in equities requires the active identification of key opportunities — and crucial risks.
- Because the market is unique, we believe many investors would benefit from making a separate allocation to China.

Is China rightly classified as an emerging market? In some ways, it is. Per capita GDP in China is around $10,000 per annum,[1] still well below any economy classified as "developed" in the MSCI World. China retains a relatively closed capital account; full investor access is a work in progress.

But from an equity investor point of view, China does not resemble a classic emerging market (EM). The sophistication of its companies, the depth of its markets, the breadth of its offerings, and its sheer size differentiate it from other MSCI EM countries.

These competing views of China have created an ongoing debate as to how best include China equities in investors' portfolios. In this piece, we'll discuss the unique characteristics of the Chinese market and the investment potential of China equities. We'll also explore how investors may consider gaining exposure to China equities — including the potential advantages of making a separate allocation to China — and the role that both active and indexed exposures to China can play in an overall equity portfolio.

China Is Different

Our view is that China is a special-case market, one that sits in between developed and emerging markets. Three characteristics illustrate how China is different from the rest of EM.

First, the sheer size of China's economy distinguishes it. China is the world's second largest economy (about $15 trillion) and six times the size of India, the next largest emerging market. China's economy is larger than all other countries classified as emerging markets *combined*.

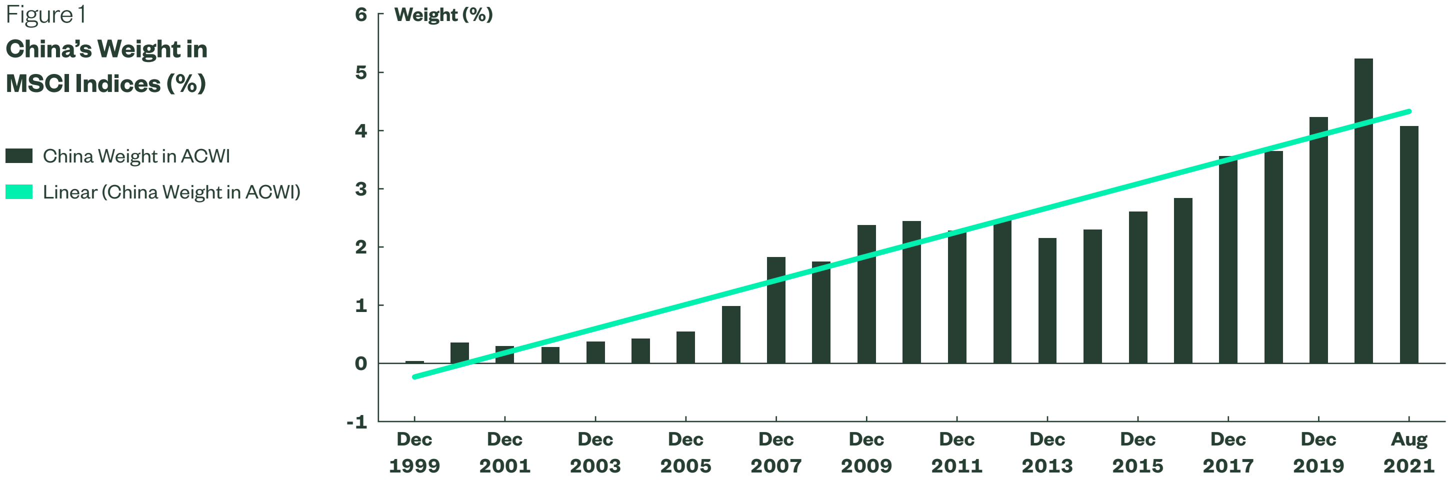
Second, China's growth remains strong. Although it has cooled down from the glory years of 8–10% annual growth, consensus growth expectations of 5% continuing from 2022 to 2026[2] still provide a lot of room for companies to grow their earnings at an attractive rate. New trade agreements, including with the EU, will allow Chinese companies to grow their share in other economic blocs. Based on historical growth levels, we expect that, by 2025, China will represent 10% of the global equity markets.

Third, the market cap-to-GDP ratio in China is currently 83%,[3] which is well below what we see in more advanced economies. This provides leverage for China, as we estimate that market cap-to-GDP should reach 100% by 2025, driven by new stock issuance and the growth of the current market. Outside the US, China is the only other country that dominates as a source of venture capital funding.

While changes in China economic policy have not always favoured the global investor, the general direction of the economy has been toward market openness. In 2010, investors were largely limited to Chinese names listed in Hong Kong and a few other, smaller, special-situation companies listed locally. A select group of investors with regulatory quotas could invest more broadly, but the rules around this were complex.

This changed with the successful Stock Connect and Bond Connect programs in 2014 and 2017, respectively. While these programs have opened the China opportunity set, A-shares remain underinvested; they are often referred to as the "largest market most investors hardly touch." We expect both the Connect programs and direct local investment to increase in size, scale, and ease, and that RMB internationalisation will slowly continue. Full capital account normalisation is not anticipated, which may keep China officially classified as "emerging" by the major index providers.

Figure 1
China's Weight in MSCI Indices (%)



Source: MSCI.

The speed with which China's market is changing is striking. If we look at the top 12 constituents of MSCI China in 2010, they look nothing like today's top 12 in China (see Figure 2). In 2010 China looked like a classic emerging market, with banks, telecoms, energy, and state-owned enterprises leading the list. Today's top names in China look remarkably similar to the top names in the US market. In China only three of the top 12 names from 2010 still appear in the top 12 of today. Ten of the today's top 12 are new economy names, which both shows the dynamism of the Chinese market and raises new questions about a resurgent regulatory environment. In light of this rapid and continuing evolution, we believe investors should consider a new way of thinking about investing in China.

Figure 2
Top 12 Names in China, Today versus 2010
% of MSCI China, as of September 15, 2021

2010		2021	
China Mobile	1.53	**Tencent**	4.15
ICBC	1.15	Alibaba	3.68
China Construction Bank	1.10	Meituan	1.50
CNOOC	1.08	**China Construction Bank**	0.87
Bank of China	0.84	JD.com	0.84
China Life Insurance	0.78	Wuxi Biologics	0.67
PetroChina Company	0.70	NIO Inc.	0.63
Tencent	0.56	**Ping An Insurance**	0.58
Ping An Insurance	0.49	Baidu	0.55
China Petroleum & Chemical Corp	0.39	Pinduoduo	0.55
China Shenhua Energy	0.36	Xiaomi	0.52
China Merchants Bank	0.25	NetEase	0.42

Source: MSCI.

As China's adjustment to new economy dynamics continues, we believe that the cycle of growth and change in the market is likely to continue over the medium term. If we look at the EM IPO calendar over the last few years, it has been dominated by China. The flood of venture capital funds looking for next-stage growth companies has found fertile ground in China. We believe standard allocation models for EM, which have focused on the cyclical nature of the asset class, the impact of the USD, and the trade channel, may not apply in the same way to China. Sustainable growth and measures of market crowding will be keys to adding alpha.

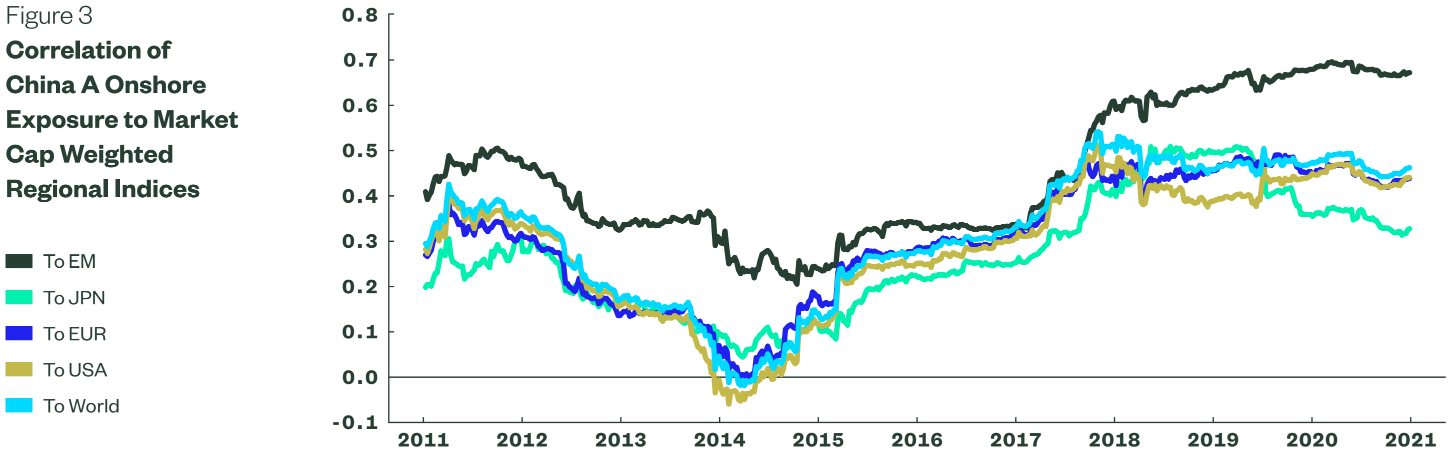
China as a Standalone Allocation

Owning China as a standalone allocation can help investors meet their return targets. Forecast returns, which comprise yield, earnings growth, valuation, and inflation components, have strongly favoured China in recent years. Though our long-term growth forecasts for China equities (6.9%) and EM equities (7.0%) have very recently converged in response to China regulatory actions and revised earnings forecasts, we believe that China's return premium will re-assert itself when markets stabilise and investors better understand the regulatory environment.

By breaking out China from EM, investors can receive a more favourable return from owning the systematic risk, which is of course higher in a China-only exposure than in a more diversified EM exposure. One of the reasons why China warrants an independent allocation is because it carries greater risk. Our forecasts put forth a long-term standard deviation of 20.9% for EM; the long-term risk forecast for China is higher, at 32.9%. This could be especially useful to investors who practice a factor-based approach and deploy capital based on a risk-budgeting framework.

China's correlations with developed markets (DM) have been rising since the inclusion of A-shares in the MSCI EM Index (see Figure 3). While we expect these correlations to increase over time, the China market still offers diversification at size.

Figure 3
Correlation of China A Onshore Exposure to Market Cap Weighted Regional Indices



Source: MSCI, FactSet, Bloomberg, State Street Global Advisors. Weekly data as of August 27, 2021.

Allocating to China in Global Portfolios

We ran an optimisation analysis on global equity portfolios and found, unsurprisingly, that strong performance and diversification benefits result from favouring the US and China. An unconstrained optimisation ends up allocating 70% to US and 30% to China. However, we recognise that for most institutional investors such an allocation would need to be constrained around relevant market capitalisation benchmarks. Figure 4 presents these results for a 60/40 investor with a market cap-based reference portfolio. Based on our analysis, such an investor may benefit from increasing their China allocations by between 20% and 100% of current levels. This implies adding somewhere between 0.25% and 0.50% to China for a typical 60/40 investor.

Figure 4
Optimisation Analysis for 60/40 Investor with a Market Cap-Based Reference Portfolio

Assets	**Constraints — Min Holding**	**Constraints — Max Holding**	**Reference Portfolio**	**Optimal Portfolio**
MSCI Emerging Markets ex-China	0.05	0.15	0.06	0.05
MSCI China All Shares	0.00	0.15	0.04	0.05
S&P 500	0.50	0.70	0.60	0.70
MSCI World ex-USA	0.20	0.40	0.30	0.20

	Equity (%)	**EM (%)**	**China in EM (%)**
	60 of 100	60 x 10	33.78 x 6.00 (*1.18)
Beginning Allocation	60.00	6.00	2.03
Potential Adjusted Allocation	60.00	6.00	2.40

Note: 1.18 multiplier = 0.40 (optimised weight)/0.3378 (current weight to China in EM). Source: State Street Global Advisors, as of October 21, 2021.

Active Management

For investors seeking to reap the longer-term potential rewards of the China growth story, we believe that an active allocation to China equities makes sense. When we have run constrained simulations on allocating to various styles in emerging markets, we have found a 70/30 mix between active and indexed investments be optimal. For China, we would recommend a similar 70/30 mix.

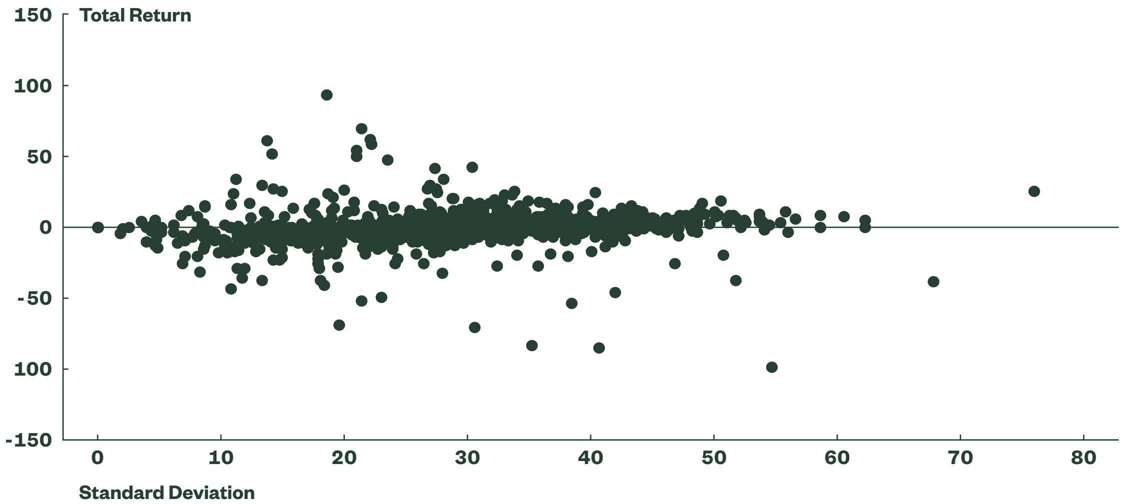
Our recommendation for a strong tilt toward active management is based on several factors. First, the level of dispersion among Chinese stocks provides active managers with the opportunity to generate excess returns. Second, it is now much more practical to take a unified, onshore and offshore approach to active equity management in China, as access to the onshore A-share market has improved. And finally, our recommendation for a strong tilt toward active reflects our high-conviction views of the many alpha opportunities — and risks — associated with China equity markets. The nature of these opportunities and risks makes the expertise of a strong China equity manager essential.

Dispersion Creates Opportunity

The breadth of the opportunity set stemming from the opening of China's A-share market, paired with increasing liquidity from the velocity of inclusion into third-party indices, create an opportunity for alpha generation. The sector composition of onshore China A-shares, in addition to MSCI China, provides active managers with improved access to mature sectors of the economy, such as Industrials, Financials, and Information Technology. Figure 5 highlights the amount of dispersion within the China All Shares universe.

While correlation shows the directional movement of securities, dispersion provides the magnitude of the difference in returns, allowing for a deeper understanding of the investment landscape. In the case of China, modest correlations and higher dispersion are supportive of active management.

Figure 5
Annualised Five-Year Dispersion of the MSCI China All Shares Index

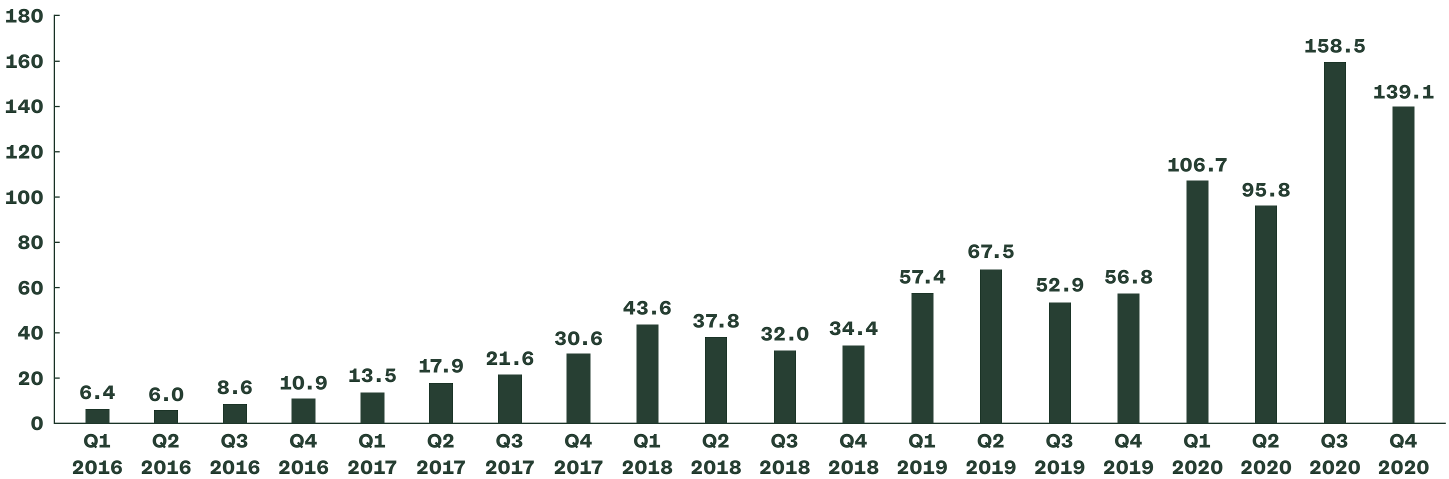


Source: MSCI, FactSet, Bloomberg, State Street Global Advisors. Weekly data, as of August 27, 2021.

Efficient Alpha Capture Through a Unified Approach

The opening of China capital markets has led to closer integration of onshore A-share markets with the offshore China equity market. The development of the Stock Connect program in particular has greatly facilitated cross-border portfolio investment flows into and out of mainland China in recent years (see Figure 6).

Figure 6
Historical Growth in Trading Volume Through Stock Connect
HK$, Billions



Source: HKEX.

This closer integration is clearly reflected in much higher return correlation between the onshore and offshore China markets today compared to five or ten years ago. The ease of access to A-shares through Stock Connect, in addition to the QFII and RQFII programs for global investors, allows for a unified China equity strategy[4] that gives active managers the whole universe of Chinese stocks from which to choose the most attractive opportunities.

We believe that this unified approach, in which both onshore and offshore stocks are treated as a single asset class, allows for more efficient alpha capture because the onshore/offshore mix would be the result of manager stock selection (rather than top-down allocation decisions). Major equity index providers now include China mainland listed A-shares in their major global and EM equity indexes, albeit using varying levels of inclusion factors.

Seeking Opportunity, Striving to Avoid Risk

Based on our years of experience in fundamental active investment in China, we believe that taking full advantage of the China growth story in equities requires the active identification of key opportunities — and crucial risks.

We see rapid changes in China's industry landscapes, driven by factors such as industrialisation, urbanisation, and technological advancement. The rapid pace of adoption of the latest information technologies is particularly notable. For example, penetration rates of mobile payment and ecommerce in China are already significantly ahead of those in the US.[5] Often, adoption of new technologies can lead to significant transformation of the competitive landscape, creating new winners and losers in the process of change.

At the same time, China still faces some of the shortcomings and risks associated with being a developing country. Many listed companies have fairly short operating histories, and their competitive positions and long-term sustainability vary widely. Most have yet to be tested by time. In addition, the quality of management at listed companies is very uneven compared with those in more developed markets. One direct manifestation of this is that there have been, and we believe will continue to be, great divergences in business performance and stock returns among the listed companies in China.

Finally, the evolving regulatory environment is an important factor that China equity investors will need to consider. Regulatory changes will have an impact on industries and on companies. While regulatory changes may appear to be unpredictable to outside observers, an experienced China manager with deep local understanding will likely be in a better position to navigate these challenges. We do expect that the current regulatory cycle will have a longer-lasting impact on China's equity market valuations and on the equity risk premium associated with holding China equities, compared to similar past cycles. This is because the current cycle is affecting more of the market than previously. In particular, the current cycle is affecting the Internet sector, which accounts for about 40% of MSCI China by index weight. For affected sectors and stocks, the regulatory cycle creates substantial uncertainty for future net income margins and revenue growth.

The Role of Indexing

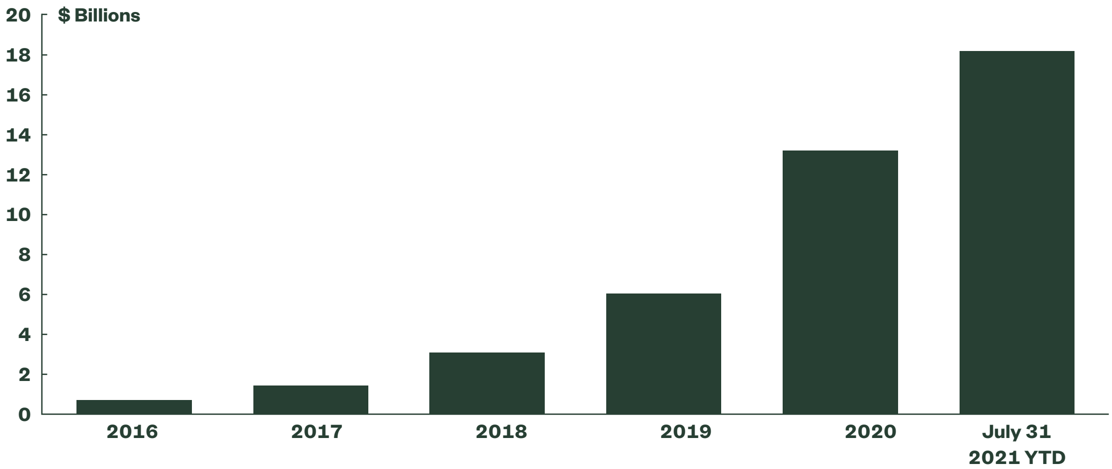
We believe there is a role for both active and indexed investments to achieve the goals of a dedicated China equity allocation. China is the most liquid equity market within MSCI EM; an indexed allocation to China can offer liquidity, ease of implementation, and low cost to investors seeking a tactical allocation to meet their needs.

State Street Global Advisors has been managing passive emerging market assets for over 25 years, and over this period the composition of the indices has changed quite drastically. Up until a few years ago, foreign index investors primarily obtained exposure to Chinese equities that were listed on non-local exchanges — namely via Hong Kong- and US-traded lines — with only a limited number of relatively illiquid, mainland, locally traded “B” shares available to these investors. The complex license and quota application process for QFII and RQFII investments made it difficult for foreign investors to access the domestic Chinese A-share market.

This all changed, however, with launch of the Hong Kong (HK) Connect Program. The Shanghai Connect scheme launched in late 2014, followed by the Shenzhen scheme two years later in 2016, and these channels provided a more straightforward way for foreign investors to gain exposure to mainland A-shares, as no license or individual quota was required. Major index providers such as MSCI, FTSE, and S&P, in turn, all have added the A-share class to their main benchmarks over the last several years, gaining access via the HK Connect program.

Index investors now have access to a wide range of domestic stocks, given that the coverage of the A-share universe that can be acquired via the HK Connect program is quite extensive (over 80% of the total A-share universe is available via HK Connect). Liquidity is also quite robust in the A-share space. Daily aggregate volumes traded of A-shares, including those traded via the RQFII/QFII/HK Connect schemes, have increased over time and measured $185 billion as of July 31, 2021.[6] The share of this aggregate daily volume represented by the HK Connect portion also has increased steadily over time, now measuring $18 billion[7] and accounting for approximately 10% of total A-share volume traded (up from only 1% in 2015)[8]. See Figure 7.

Figure 7
HK Connect Average Daily Turnover
$, Billions



Source: HKEX, as of July 31, 2021.

The addition of the A-share class to indices tracking EM (and those tracking broader indices) has greatly increased both the number of names as well as the market cap of the Chinese equities that foreign investors now have exposure to. The major indices now include several hundred liquid A-share names, making them more representative of the opportunity set in China. If the goal of an investor is to broadly own the Chinese equity market, investors can now do so via an index investment, which arguably wasn't the case five years ago. While the addition of A-shares helps to provide a more representative basket of Chinese equities, and to lower the single-stock concentration risk in a market-cap-weighted index, China as a whole is now roughly one-third of the broader EM universe, and over twice the size of any other country. Furthermore, roughly 75% of an EM index investment comprises stocks from the Asian region. That said, investors may choose to allocate to China separately and can do so via an index investment, whether increasing or decreasing their relative exposure to China.

An Attractive Market

With the recent decline in China equity valuation, we think current valuation levels are attractive on a tactical basis; however, based on some of the risks discussed, we believe that investors should demand a higher equity risk premium for China equities.

MSCI China's forward price-to-earnings ratio of 13.0 implies a 4% valuation premium when compared to MSCI EM ex-China. The current premium is relative to a long-term average discount of 5%; valuations have dropped by about 40% since the February 2021 peak for MSCI China. Over time, we expect the MSCI China universe gradually to have a more balanced sector allocation, with a reduced weight for internet stocks and a higher weight for sectors like Industrials and IT — hence we see MSCI China trading at par with EM.

For long-term investors this means that current valuation levels offer a reasonable opportunity to add to emerging markets; the 40% discount on China equities underscores the nature of the opportunity.

The Risks of Investing in China Equities

Throughout this paper, we have highlighted both the risks and opportunities available to investors in China. And while we remain constructive overall, the choices for investors will likely be more complex as growth slows and geopolitical tensions increase.

Slowing growth always forces related issues to the forefront, and China is no exception in this regard. Clearly, the changing usage of regulatory powers to achieve social outcomes has affected investors' portfolios this year. And while we believe that the Chinese government wants capital flows to continue, more careful scrutiny of the country's regulatory framework will be needed.

Likewise, rising leverage will need to be monitored. We do not expect any systematic failures, but large, idiosyncratic events (such as Evergrande) will need to be worked out in a fair and orderly manner. The simple story of "China = growth = buy" is more nuanced now, but the opportunities are still present.

Closing Thoughts

The sheer size, growth trajectory, and speed of change of China's equity market distinguish it from other emerging markets. Because the market is unique, we believe many investors would benefit from making a separate allocation to China. This may allow investors to not only be better compensated for the systemic risk they take on by owning Chinese equities, but also to create greater flexibility for investors to adjust their China equity exposure in line with individual return and risk requirements.

Within the China equity allocation, we believe that a strong tilt toward active management would help investors to take best advantage of the China growth story, as active managers with deep local ties and extensive experience in the country are, in our view, well placed to identify the opportunities that accompany a rapidly changing business landscape, while avoiding the inevitable pitfalls of the same. At the same time, indexed exposures to China equities can have an important tactical role to play, as their liquidity and ease of implementation allow for swift adjustments as conditions and requirements change. The opportunity in China equities should not be underestimated; neither should the risks.

For more information on China equity investment at State Street Global Advisors, please contact your relationship manager.

Endnotes

1 IMF, 2020.

2 IMF.

3 World Bank, 2020.

4 Investing in both offshore and on-shore (A-share) share classes.

5 The total mobile payment volume in China in 2020 was RMB432 trillion, or about US$66 trillion, while the total credit and debit card payment (mobile or otherwise) was only US$7.1 trillion in 2018. E-commence penetration in China reached about 25% in 2020, while it was about 20% in US.

6 CSINDEX, Bloomberg, MS Execution Services.

7 As of July 2021.

8 HKEX, MS Research.

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- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of September 30, 2021 and includes approximately $59.84 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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Investments in emerging or developing markets may be more volatile and less liquid than investing in developed markets and may involve exposure to economic structures that are generally less diverse and mature and to political systems which have less stability than those of more developed countries.

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