Ampersand Institute

CHINA A SHARES: WHY, WHEN AND HOW?

IMPROVING YOUR PORTFOLIO

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THE CURRENT STATE

Amongst the myriad of complex problems that institutional investors are tasked with solving, we believe there are some parts of the portfolio where relatively straightforward improvements can result in significantly better outcomes. The equity allocation is one of these.

Whilst some hold the view that equity allocations are less important to pension funds as they move towards full funding and into de-risking mode, they still dominate pension fund assets (c.40% of the overall asset allocation globally) and are a meaningful contributor to overall portfolio returns.

Considering less mature pension funds remain heavily reliant on exposure to equities to get the returns required, equity allocations are still significant in more mature pension funds (~75% of Redington clients have some form of equity exposure, despite many being well funded).

Add to that DC allocations and default strategies, and equities remain a very important and strategic asset class.

Given their significance, we believe it's important for these allocations to be invested as optimally as possible.

It is common to see equity portfolios that consist solely of simple global passive funds with perhaps some legacy domestic equity. This is often driven by a desire for low fees, simplicity or a bias towards UK/US. We believe this overlooks important areas of the market and opportunities for excess returns – namely, domestic Chinese equities.

REDINGTON

CHINA A SHARES

The onshore Chinese listed market "China A Shares" is large, liquid and less correlated with traditional equity markets and business cycles. All these elements are exactly what investors should be looking for when it comes to diversifying their equity portfolio.

THEN WHY IS IT SUCH A RARE SIGHT IN INSTITUTIONAL INVESTORS' PORTFOLIOS?

The reason comes down to availability. Up until recently it was very difficult for foreign investors to access the onshore Chinese equity market. However, with increased financial liberalisation the majority of the market capitalisation is now easily accessible to outside investors.

HOW LARGE IS IT?

The Chinese equity market now has the second largest market capitalisation in the world, sitting between the US and Japan.

In terms of economic output and growth in global output, Asia is now similar to the US and the Eurozone combined, and expected to pull ahead in the forthcoming years.

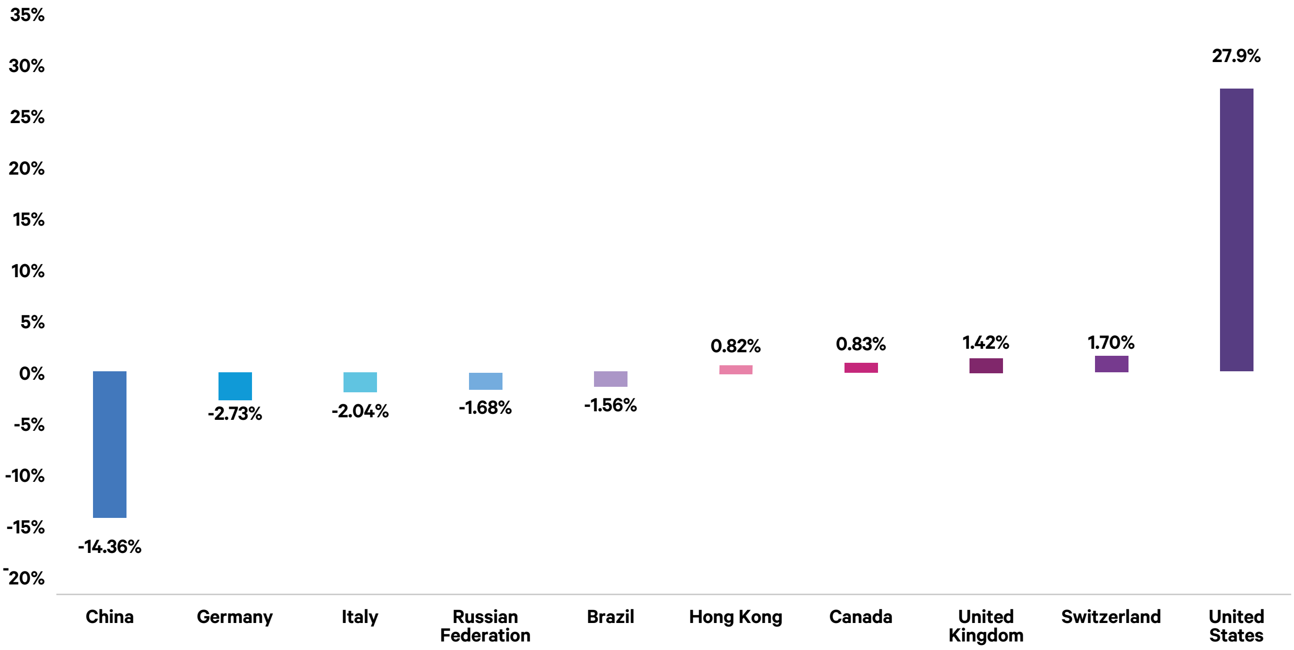
Due to its historic closed off nature (despite its size) the market is very much underrepresented in indices and investor portfolios.

The graph below compares the market capitalisation weights of different countries in the MSCI World All Country Index, with the weight that would be expected from weighting according to GDP. In general, developed market countries tend to be overweight in market capitalisation relative to GDP, and developing market countries tend to be underweight; but a large part of the difference is accounted for by two countries, China and the US.

As such, moving a portion of assets from developed world equities to China A equities is one way of moving closer to an equity portfolio that reflects GDP rather than simple market capitalisation. Whilst there is no guarantee that this will lead to outperformance, the GDP weighted MSCI All World Index has outperformed the market capitalisation weighted version historically; albeit not to a statistically meaningful extent.

Given the size, we believe that neglecting allocations to onshore China in an emerging market portfolio is comparable to neglecting US allocations in a developed market portfolio.

Market Cap vs GDP: 5 Largest Underweights and 5 Largest Overweights



Source: Bloomberg, Redington, as at Dec 2018

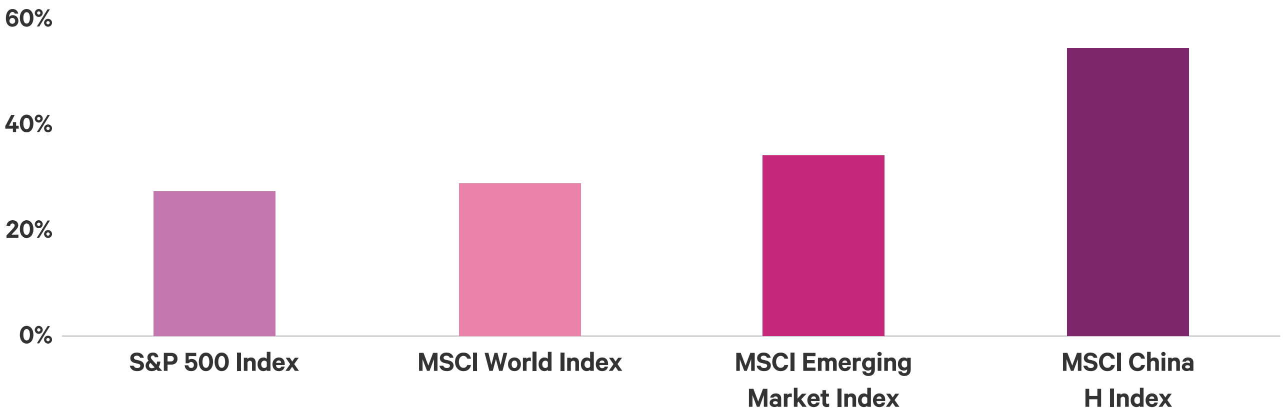
LOW CORRELATION WITH OTHER MARKETS

The closed off nature also means the market still sees 80% of trading coming from domestic investors (a large portion being retail), hence it behaves very differently from the rest of the world. (It even shows a relatively low correlation with the offshore MSCI China H index!)

While these correlations could change over time, particularly if foreign investors become the majority investor base, they are driven at least in part by the difference in economic cycles, which are in turn driven by a large domestic economy and an independent monetary and fiscal policy.

Adding exposure to assets with low correlations that are expected to remain low in the medium term can significantly improve the risk/return characteristics of your portfolio.

China A trading correlation with the rest of the world



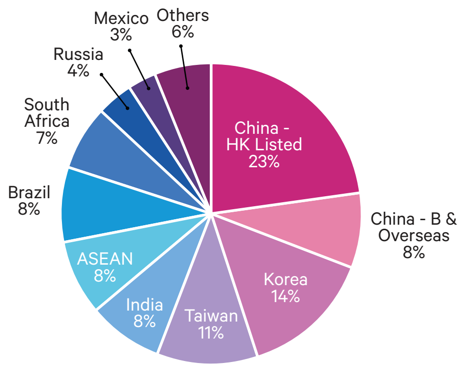
Source: BlackRock, Bloomberg, 5Y 20-day correlation as at 31 March 2018

CATALYSTS FOR CHANGE

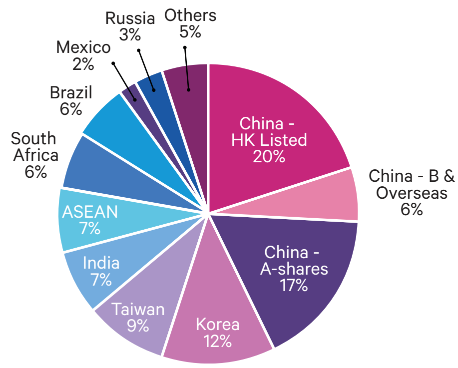
As the market opens up, index providers are beginning to take notice.

MSCI have already begun to include China A shares in its indices with FTSE closely following suit. If they continue their road to financial liberalisation, their size could one day be fully represented in indices – at which point it will be too large for institutional investors to ignore. It therefore makes sense for investors to start considering the asset class now.

Pre Inclusion MSCI EM Index



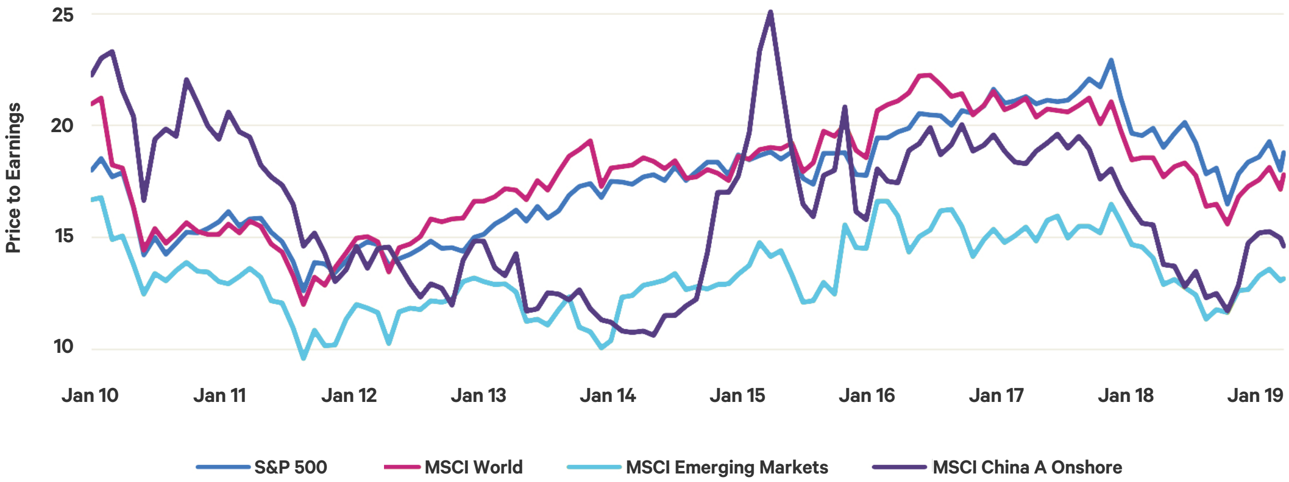
MSCI EM with 100% FIF of A Shares Inclusion



Source: Lazard, as at March 2018

VALUE IN THE MARKET

On most valuation measures, China appears attractively valued, in line with emerging markets, and at a significant discount to the US (which makes up over 60% of the MSCI World benchmark). Simple valuation measures come with various caveats and are certainly not guarantees of positive future returns, but it would appear that if there is potential within this market it has not been priced in relative to others.



Source: Redington, Bloomberg, as at June 2019

SO HOW SHOULD I ACCESS THESE MARKETS?

Given the above, we believe that considering a dedicated allocation to these areas could be an improvement to many current equity allocations.

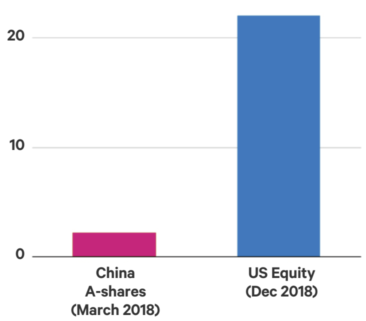
To really see the benefit, we would recommend choosing an active manager. These markets are far more inefficient and under researched than their developed counterparts, and as such, we believe, this creates a fertile hunting ground for stock pickers with a long term view. We have completed extensive research in this area and the potential for scalable alpha is, in our view, unparalleled. We have a number of reasons for this belief:

DEEP RETAIL INVESTOR BASE

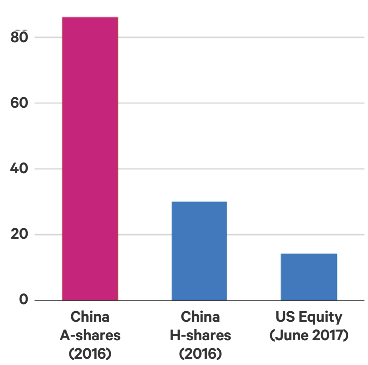
The China A market is highly liquid and currently dominated by local retail investors.

We believe the lack of institutional investors increases the potential for stocks to be mispriced.

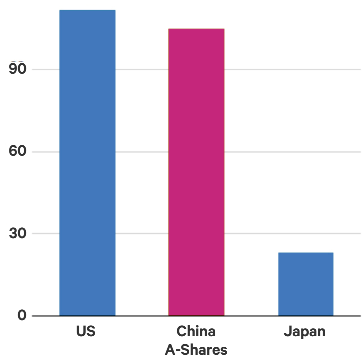
Level of foreign institutional ownership (%)



% of trading volume by retail investors



Average daily turnover (US$ bn)

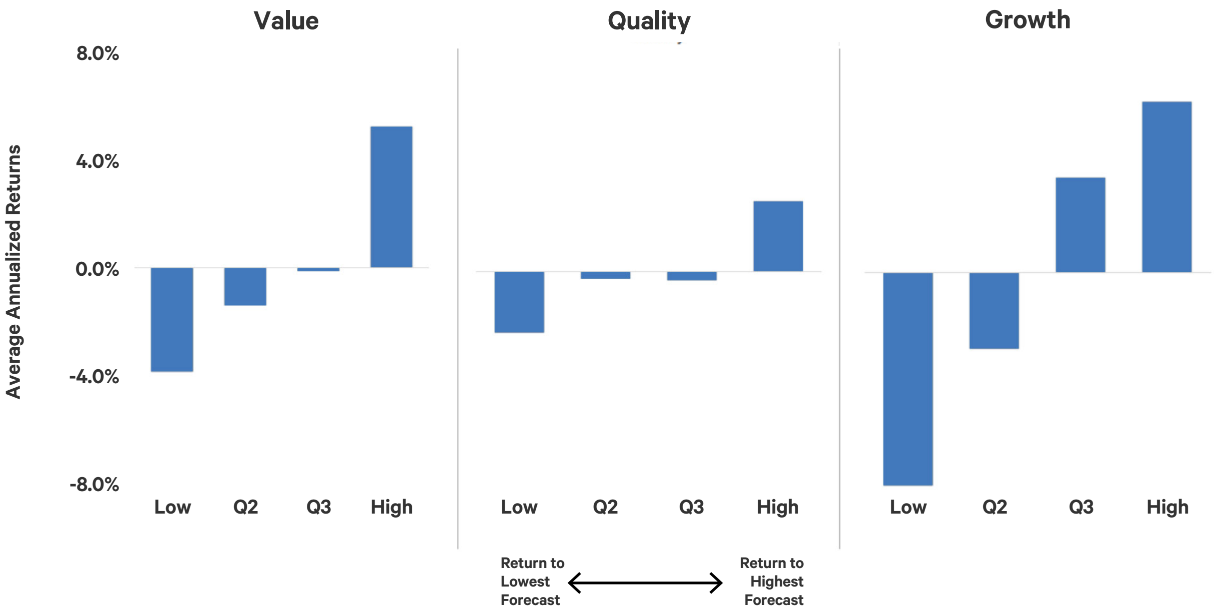


Source: Wellington, as at March 2018

EVIDENCE OF INEFFICIENCIES

The chart below shows how quantitative factors focusing on value, quality and growth performed historically. All three have worked well, with stocks with these characteristics significantly outperforming those without.

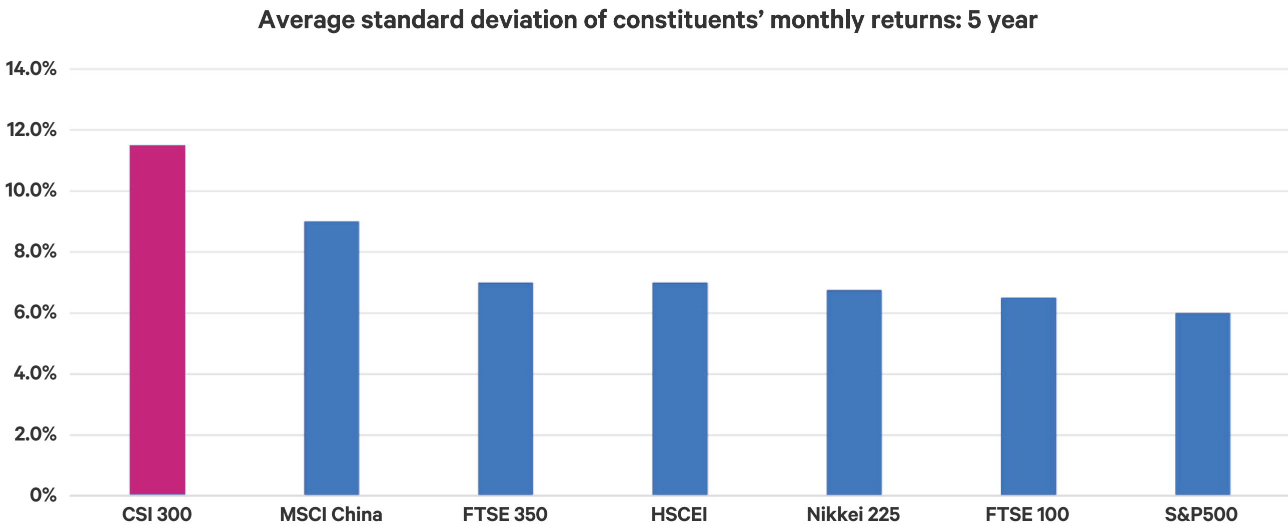
This suggests that the market is inefficient at pricing in these factors and can be exploited by sophisticated investors.



Source: Acadian (Start date 01/2008, End date 12/2017)

IT'S A STOCKPICKER'S MARKET

High dispersion of returns within the A-Share market suggests a favourable environment for active stock picking.

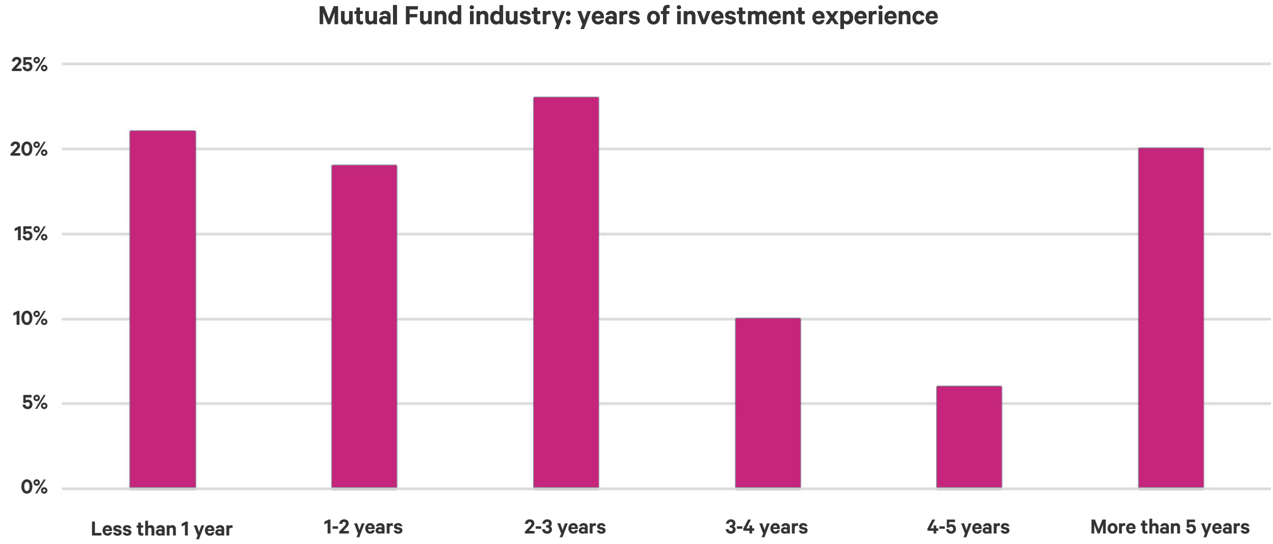


Source: BlackRock, as at 31 March 2018

THE COMPETITION IS INEXPERIENCED AND SKILLED MANAGERS CAN EXPLOIT THIS

There are many relatively inexperienced professional investors in China.

Approximately 60% of the Mutual Fund investors have less than 3 years' investment experience (evidenced below).



Source: Taikang AMC, WIND, Redington. Data as at 31 December 2017. Data covers all the active equity mutual funds within China, covering 1731 mutual funds and 971 portfolio managers

CHINESE ASSETS ARE RISKY

There are risks associated with anything that offers an expected return, and China is no exception.

It carries risks associated to any emerging market in terms of accessibility by foreign investors, investor legal protection and political stability. However, these risks are present in other emerging markets and indeed in some developed markets.

Chinese equities have historically been significantly more volatile on a standalone basis. That said, when combined with other assets as part of a diversified portfolio, the lower correlation previously demonstrated can offset much of this volatility at an overall portfolio level.

SO WHAT DOES THIS MEAN AND IS IT WORTH IT?

Using conservative assumptions, our modelling shows how moving from a passive portfolio of developed market ('DM') equity to a portfolio that includes active emerging markets ('EM') and a China A allocation, can substantially improve efficiency.

WHAT IS THE RESULT?

The improved Sharpe Ratio when incorporating China A Shares should materially help investors achieve their objectives.

We believe opportunities like this are rare and should prompt investors to consider whether a higher allocation to China A Shares, via a dedicated allocation and/or a higher EM weighting, could improve their equity portfolio and ultimately its chance of success.

	100% Passive DM	70% Passive DM & 30% Active EM	65% Passive DM, 25% Active EM & 10% Active China
Expected Return (Cash+)	**4.4%**	**4.7%**	**4.9%**
Volatility	**16.5%**	**16.5%**	**15.8%**
Sharpe Ratio	**0.27**	**0.29**	**0.31**

Source: Redington ADA, as at 31 March 2019

DISCLAIMER

For more information on the impact of China A Shares, please speak to your Redington representative or email **communications@redington.co.uk**