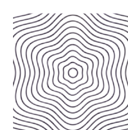
When Opportunity Knocks: The Case for Investing in Chinese Equities

Fullerton Insights
February 2021



FULLERTON FUND MANAGEMENT

Executive Summary

China is globally dominant - being the largest consumer market in the world, the largest economy (on a Purchasing Power Parity basis), and classified as upper middle income by the World Bank. Its equity market has grown to become the second largest in the world and yet foreign investors have an extremely low ownership stake at just 3.8%[1]. Given China's importance in the global economy, why haven't foreign investors embraced the full range of growth opportunities China presents?

One reason could be some unfamiliarity with foreign companies and the language barrier (as many Chinese listed companies only report in Mandarin). Another potential factor is that China is still reforming its financial markets, opening-up, and strengthening its corporate governance. It may also reflect that many foreign investors believe they have sufficient Chinese exposure via Global Emerging Market (GEM) holdings or other benchmarks in their portfolios.

In a 'deeper-dive' into China's equity market, we highlight key takeaways as to why China could be an attractive destination for long-term investors[2], and reasons why some common excuses for being underinvested in China might be reassessed.

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Ongoing reforms will make China more attractive to foreign investors

In February 2020, China's key policymakers published a new plan to accelerate the development of Shanghai into a key international financial centre by 2025. China will continue to enhance its financial sector infrastructure across regulatory, audit and legal fronts.

In the latest Global Financial Centres Index (GFCI #27, March 2020), Shanghai is already ranked at number 4, just behind Tokyo, as a global leading financial centre (across banking, insurance, and investment management). The International Monetary Fund (IMF) has praised China for its financial stability throughout the COVID-19 pandemic and ascribed part of its success to financial reforms designed to build deep and broad capital markets, strengthen financial regulations, and corporate governance. Collectively, these factors are likely to continue to make China an attractive investment destination to foreign investors over time.

China's macro fundamentals continue to grow and develop along very favourable trends

- robust increases in GDP per capita
- strong growth in corporate R&D
- low sovereign debt
- rising domestic consumption
- and, beneficial trade agreements – the 'One Belt, One Road' initiative, and the most recent Regional Comprehensive Economic Partnership should be positive over the longer-term for Chinese companies that are most leveraged to international trade.

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[1] as at June 2020, Goldman Sachs

[2] This Investment Paper completes a trilogy. Our first paper (released in June 2020) gave an overview of some of the key features that make China's equities and bonds an appealing risk-reward proposition (The Changing Dragon: Exploring Opportunities in China). We then released a follow-up paper in August 2020, which was an in-depth study into investing in China's bond markets (A Journey of a Thousand Miles Begins with a Single Step: The Case for Investing in Chinese Bonds).

China also offers strong growth opportunities across its ‘new economy’ sectors

China’s favourable macro trends, especially rising disposable incomes and greater middle class spending, have driven stronger earnings growth across new economy sectors (i.e. consumer staples, consumer discretionary, media and entertainment, technology, and healthcare). Sustained growth in market share across these new economy sectors will continue to offer valuable alpha opportunities to investors.

China’s supply-side reforms should result in stronger economy wide Return On Equity (ROE)

While China’s equities have sustained reasonable returns over time, they have still faced headwinds from some State Owned Enterprises (SOE) struggling to improve their profitability. However, China’s supply-side reforms, especially those started over 2016-18, should help improve SOE profitability over time by reducing overcapacity. In addition, as the weight and performance of China’s new economy sectors continues to improve, we would expect China’s economy-wide average ROE to also increase.

Chinese companies that embrace ESG should provide attractive alpha opportunities

We believe that the stocks of Chinese companies that can sustain higher ESG standards are likely to enjoy superior returns versus companies with poor ESG standards – thereby continuing the trend of the last 7 years where China’s ESG and climate-based indices outperformed their MSCI parent indices (with similar risk levels).

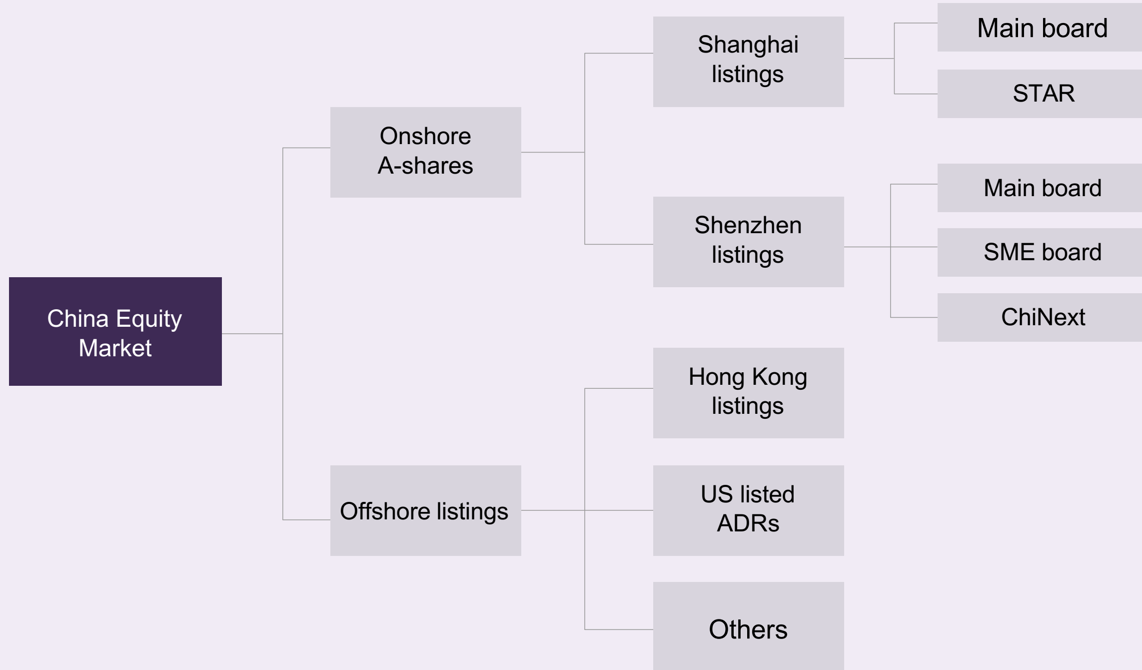
This paper also contains two special features on related topics **“How to invest in China’s equity market”** and **“How can investors reap the benefit of the ESG transformation taking place in China?”** which provide further granularity on how investors can gain exposure to this dynamic market.

How to invest in China's equity market?

1. Which 'equity market' to choose?

China's equity market ('All China') comprises A-share i.e domestic listings (across Shanghai and Shenzhen stock exchanges) and offshore listings (see Figure 1).

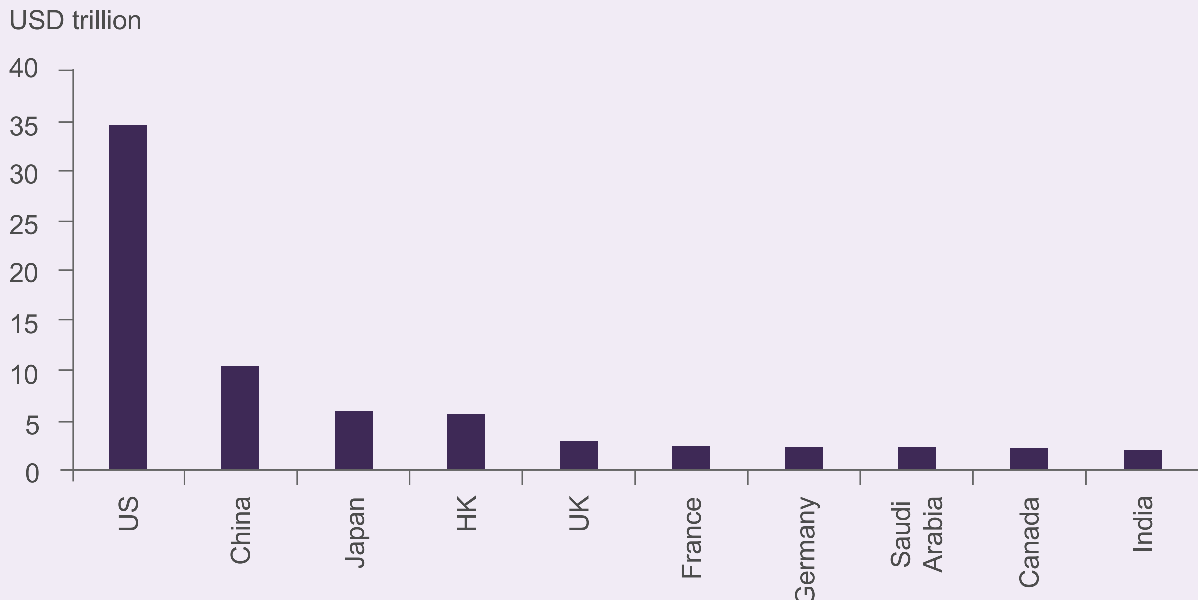
Figure 1: China equity market structure



Source: Morgan Stanley 15 July 2020

China's domestic equity market is massive, with more than 4,000 listed companies and an aggregate market cap of over USD$10 trillion (in contrast, China's offshore market has less than 1,500 listings and a market cap of about USD$1.4 trillion). China's domestic equity market is the second largest in the world, behind the US and ahead of Japan (see Figure 2).

Figure 2: Total market cap across global stock exchanges



Source: Bloomberg and JPM. As of 29 July 2020

Across China's equity market there are different groupings of share types that give investors various options (see Figure 3):

- sector coverage (across domestic firms, SOEs, and multinationals)
- shares denominated in local or foreign currencies
- offshore versus onshore

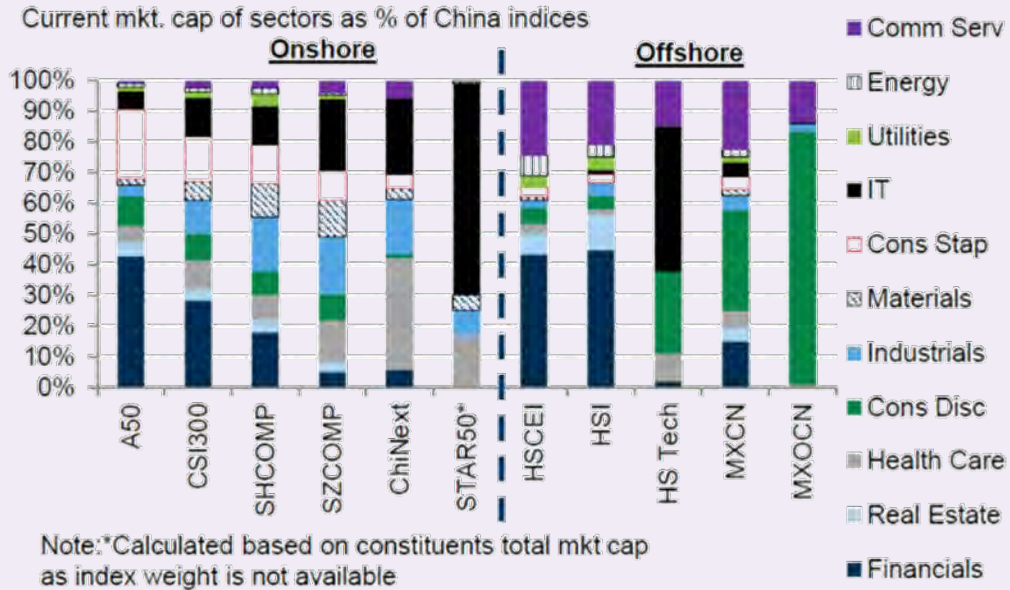
Figure 3: China's share types

Share Class	Country of Incorporation	Country of Listing	Trading Currency	Available to mainland Chinese investors	Available to other investors
A Share	People's Republic of China (PRC)	China	CNY	Yes	Yes under QFII/ RQFII/Stock Connect programs
B Share	People's Republic of China (PRC)	China	USD (Shanghai) HKD (Shenzhen)	Yes (if they have appropriate currency accounts)	Yes
H Share	People's Republic of China (PRC)	Hong Kong	HKD	Yes if QDII approved or under Stock Connect programs	Yes
Red Chip	Non-PRC	Hong Kong	HKD	Yes if QDII approved or under Stock Connect programs	Yes
P Chip	Non-PRC	Hong Kong	HKD	Yes if QDII approved or under Stock Connect programs	Yes
S Chip	Non-PRC	Singapore	SGD	Yes if QDII approved	Yes
N Share	Non-PRC	United States	USD	Yes if QDII approved	Yes

Source: FTSE Russell, December 2019

Onshore markets have relatively more companies across the new economy sectors (like media and entertainment, technology, healthcare, consumer staples, consumer discretionary, and new industrials serving consumer demand - see Figure 4). Offshore markets comprise relatively more companies across services, real estate, consumer discretionary, and financials - and are more correlated with global markets.

Figure 4: China equity market structure: onshore and offshore with sector weights



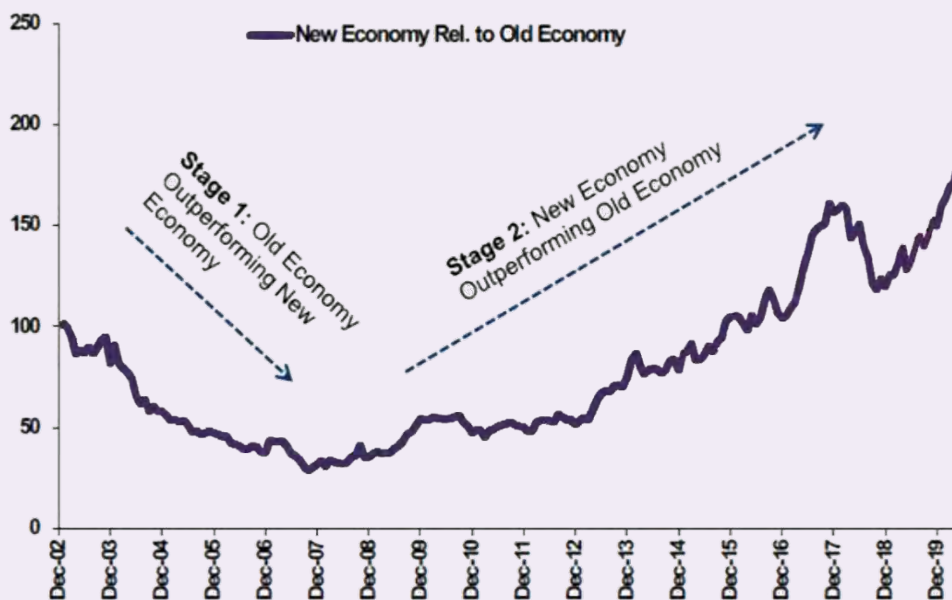
Source: Goldman Sachs 28 October 2020

With so many options, where should investors focus?

Prior to Stock Connect (between Shanghai and Hong Kong in November 2014 and expanded to link Shenzhen and Hong Kong in December 2016), foreign exchange controls, investment quotas, and lockup periods, collectively limited investor access to domestic shares. Now that onshore markets have opened up more, the distinction between onshore and offshore markets is becoming increasingly irrelevant – investors can select from any market to get the sector, and currency exposures, that they are most comfortable with.

If investors are seeking local currency exposures, with good coverage of the fast growing new economy sectors, then the China A-share universe captures that.

Figure 5: Rising importance and performance of China's 'new economy' stocks



Source: Morgan Stanley, 15 July 2020, MSCI China sector level sub-indices are used to construct performance index for 'new economy' (consumer staples, consumer discretionary, media & entertainment, IT, healthcare) and 'old economy' (materials, energy, industrials).

China A-share new economy stocks also tend to have the advantage of having lower exposures to ESG risks (than old economy stocks, like oil, gas, and mining. See Figure 6).

Figure 6: Exposure to ESG risks across China's equity sectors (% pts)

Source: Sustainalytics, as at Dec 2020

2. Why make China a distinct allocation?

In our earlier paper, we argued that investors should segregate their exposures to China from country aggregates (especially Emerging Market indices) because all these vehicles give insufficient exposure given China's rising economic power.

Granted, China's weight in key global benchmarks is also rising, and eventually in the years ahead, full-inclusions will be reached. However, because China's domestic equity universe is so huge many key sector trends will still be underrepresented to index investors.

3. Active management or index-based investments?

In seeking an investment exposure to China, a common question is - "Should investors focus on stock selection and active management or on index-based investments?"

First and foremost, historical performance data reveals that active management of Chinese equities can significantly outperform index-based investments (The Changing Dragon: Exploring Opportunities in China, p.7)

Active management has the advantage of allowing investors to better capture the underlying sector drivers of China's economic performance, especially its new economy sectors, which are benefiting the most from the rise of middle class spending. In seeking alpha opportunities, investors can also underweight old economy sectors that may lag as China continues to rebalance toward a consumption driven economy.

Active management also enables investors greater exposure to companies with stronger ESG credentials. By engaging on ESG issues from a 'bottom-up' perspective, investors can identify the companies best positioned to navigate ESG risks and opportunities. While ESG reporting in China is still evolving, there are already many opportunities that fund managers can 'cherry-pick' from.

Ongoing policy reforms will continue to increase the attractiveness of Chinese risk assets to foreign investors

In February 2020, China's key policymakers published a new plan to accelerate the building of Shanghai into a stronger international financial centre by 2025. Policymakers have re-emphasised that the financial services sector in China must be fair, under the rule of law, innovative, efficient, transparent and open. Platforms that encourage more foreign investor participation, such as the Stock and Bond Connect, continue to grow strongly.

China's policymakers remain highly motivated to make their risk-asset markets attractive and accessible to foreign investors. As such, China's policymakers will continue the gradual internationalisation of the RMB over time and make the currency more sensitive to market forces (such as capital flows and interest rate differentials). China will also continue to enhance (and better align with international standards) its financial sector infrastructure across regulatory, audit and legal fronts.

In the latest Global Financial Centres Index (GFCI #27, March 2020) Shanghai is already ranked at number 4, just behind Tokyo, as a global leading financial centre (across banking, insurance, and investment management). The International Monetary Fund has praised China for its financial stability throughout the COVID-19 pandemic and ascribed part of its success to the strong role of government-owned financial institutions coupled with financial reforms designed to build deep and broad capital markets, strengthen financial regulations, and corporate governance[3]. Collectively all these factors will continue to make China an attractive investment destination to foreign investors over time.

China will become a key pillar of investors' global equity portfolios - on the back of its solid fundamentals and superior growth in new economy sectors

Strong fundamental trends make China an attractive investment destination

China's macro fundamentals continue to grow and develop along very favourable trends:

- Rising middle class spending and consumerism - China is an economy that is increasingly powered by domestic consumption rather than exports.
- Robust growth in per capita incomes – China's consumer 'spending power' has more than doubled since 2010 to almost $11,000 USD. Before the COVID-19 driven recession hit, China's per capita income growth averaged 6.3% YoY over 2016-19. Looking ahead, China's per capita income growth is likely to remain solid, especially as China's policymakers focus increasingly on improving the 'quality' of growth outcomes over time (see Figure 7).
- As China pushes to grow its tech sectors even further, under its 'Made in China 2025 plan', it is committed to maintaining strong growth in spending on R&D over the years ahead (see Figure 7).
- China's general government gross debt is low by international standards (at less than 70% of GDP)[4] and China is a net creditor to the world. This is important because it means that China's policymakers have large resources to reform the economy and to give significant stimulus when growth is stressed.

Collectively these are China's most significant and sustainable trends that investors should give the most weight to when considering opportunities in China. From the cyclical perspective, China has managed to recover strongly from the COVID-19 driven recession. According to Refinitiv Datastream, China's GDP growth has already recovered to pre-COVID-19 rates (6.5% YoY Q4 2020), and the Bloomberg Consensus forecasts a bullish 8.4% YoY growth for 2021[5].

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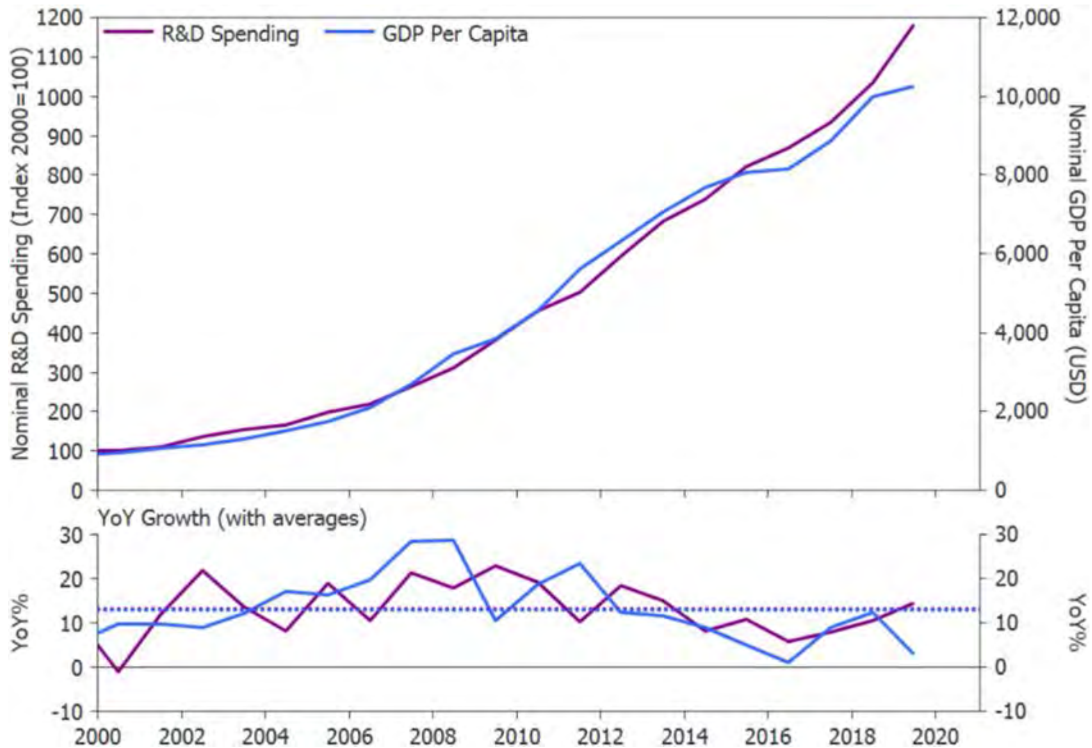
[3] IMF Global Financial Stability Report, April 2020

[4] IMF as at Jan 2021

[5] as at 2 Feb 2021

Figure 7: China's GDP per capita and R&D spending



Source: Refinitiv Datastream, 22 Jan 2021

Over the last decade, China's robust macroeconomic fundamentals have undoubtedly contributed to its strong earnings growth performance and favourable investment returns, especially in comparison to Emerging Markets (EM). For example, China's A-shares have enjoyed double-digit Earnings Per Share (EPS) growth over the last decade, which was 2% p.a. stronger than across EM (see Figure 8). China's robust EPS growth has translated into strong equity returns as MSCI China has outperformed the MSCI EM index (see Figure 9).

Figure 8: EPS growth from China-A shares vs the rest of the world

Source: Goldman Sachs 28 October 2020

Figure 9: MSCI China returns vs MSCI EM

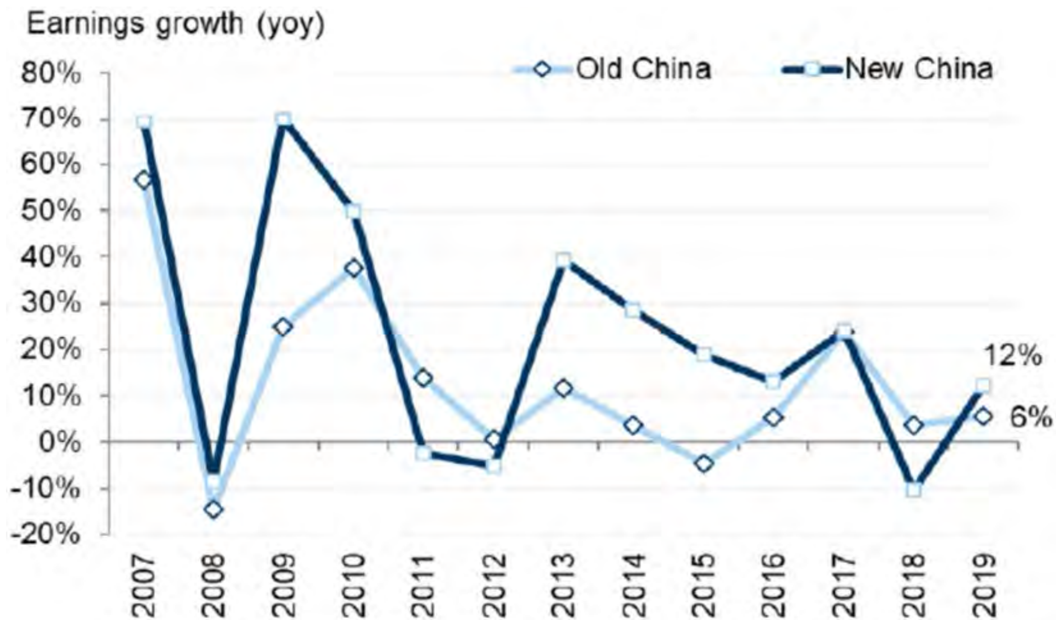
Total Return In US$	MSCI China	MSCI EM
15Yr CAGR	11.2%	6.7%
10Yr CAGR	6.6%	3.6%
5Yr CAGR	5.5%	3.2%
3Yr CAGR	8.7%	2.3%
1Yr CAGR	13.3%	-3.0%

Source: Morgan Stanley 15 July 2020

China's re-balancing toward consumption is creating a new economy driven by spending

As China's middle class spending power continues to rise, its new economy sectors are enjoying very strong growth, especially across consumer staples and IT. Earnings growth from new economy stocks has been much stronger than older economy stocks and this trend is unlikely to reverse (see Figure 10).

Figure 10: Earnings growth across 'new economy' stocks vs 'old economy' stocks



Source: Goldman Sachs 28 October 2020

It is not just consumption linked investments that stand to prosper but also investments linked to banks and insurance companies as China's rising middle class drives stronger demand over time for financial products and retirement-linked investing.

China gives investors access to healthcare and global tech leaders

China is already a global technology and innovation hub and is much more integrated with global financial markets, industry and trade than many other countries. With the government's focus on healthcare, as both a social priority and a strategic objective, China's pharmaceuticals industry is a world leader and a major market for health related multinational companies.

Technology and e-commerce giants such as Tencent and Alibaba are recognised today as global leaders and innovators in their field (both are ranked within the Top 10 of the largest tech companies in the world). Baidu owns the largest search engine in China, and is a world leader in artificial intelligence (AI) and autonomous vehicle technologies. JD.com has invested heavily in AI & automation, and is believed to have the largest drone delivery system in the world.

Investors can gain exposure to China's massive consumer market and the huge potential growth in global market share

Much of the success of China's tech companies stems from their business models i.e. providing multiple services to consumers. Many of these companies have grown significantly with the expansion of China's middle class spending and because foreign competition is minimised.

The big attraction for investors in China's tech companies is not just the exposure to China's massive consumer market, but also tapping the huge potential growth in global market share – as penetration outside of China is still low. Some Chinese companies are already establishing strategic partnerships to help them expand their global market share over time e.g. US Walmart has a 12% ownership stake in JD.com.

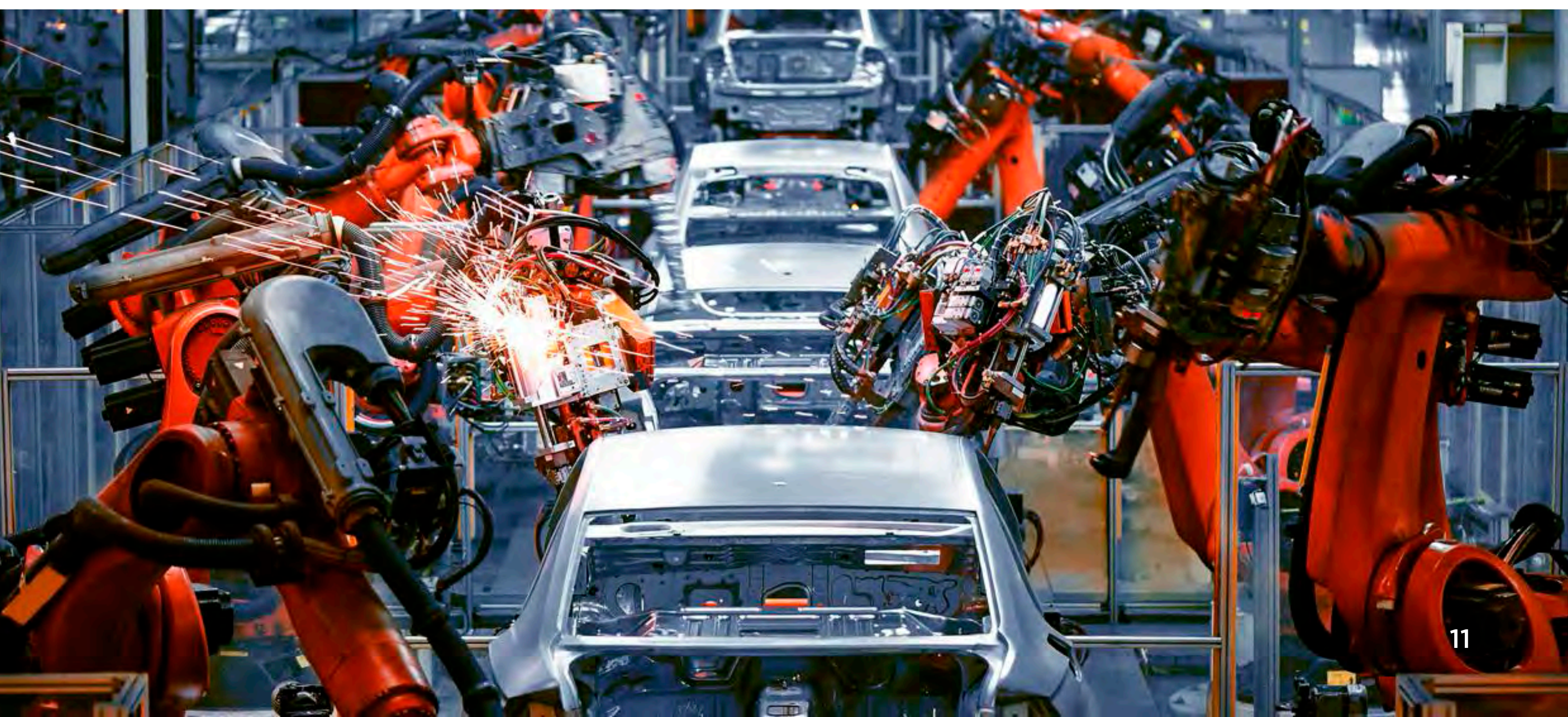
Figure 11: Chinese firms across multiple industries have significant scope to expand their global market share over time

Chinese producers / Non-Chinese producers

Technology		Market share in China, %[1]	Market share in rest of world, %[1]	% of first-tier components from Chinese suppliers[1]
Leading local players with local contents	Solar panels	100	50	70 - 85
	High-speed rail	100	5	75 - 90
	Digital payments	95	10	>85[2]
Leading local players with foreign contents	Wind turbines	80	5	60 - 75
	Electric vehicles	95	5	60 - 75
	Cargo ships	90	45	40 - 50
	Agricultural machinery	88	19	60 - 80
	Smart-phones	85	25	35 - 50
	Cloud services[3]	70	8	<35
	Robotics[4]	50	15	25 - 45
Lagging local players	Semi-conductors[5]	5	5	<10
	Aircraft	<5	<1	<20

[1] Based on 2018 or the latest available data.
[2] Compares local vs imported software development costs.
[3] Servers used for cloud storage purposes.
[4] Captures only industrial robots.
[5] China and rest-of-world market shares assumed to be equal due to data availability.

Source: 'China and the World' by McKinsey Global Institute, July 2019



China will continue to be a major global manufacturing and trade hub

China's manufacturing sector is still evolving and we expect investors to benefit as it further expands its global market share into higher tech and more capital intensive industries (such as paper products, chemicals, electrical equipment, machinery, and pharmaceuticals).

There are also likely to be significant benefits from new trade agreements. One of the most exciting for investors in China and ASEAN is the Regional Comprehensive Economic Partnership (RCEP, November 2020) signed between China, Japan, South Korea, ASEAN, Australia and New Zealand.

The RCEP agreement encompasses around 30% of global GDP and will seek to cut tariffs and promote free-trade access. Such trade agreements certainly harmonise with China's 'One Belt, One Road' initiative and are likely to serve to defend and deepen Asian trade and supply-chains. Longer-term these agreements will likely be positive for Chinese equities that are most leveraged to regional trade.

Beware of potential geopolitical risks, that investors need to navigate

China is in the process of re-examining market practice regulations for its large IT corporations to make sure there are no significant monopolistic tendencies. So far China's policymakers have investigated Tencent's music publishing business and have modified some of the regulations covering micro-lending activities at organisations like Ant Group (which has forced the postponement of Ant's scheduled IPO).

These events have increased the cyclical uncertainties surrounding what new regulations may imply for China's IT/ fintech business models and have likely hurt investor confidence to some degree. However, looking out longer term, any enhancements to competitive regulations governing China's IT/e-commerce landscape could make the industry more resilient and sustainable. Domestic regulation changes may also accelerate China's tech expansion into the global market place.

The deteriorating US-China relationship could also create headwinds over time for China's companies to gain further global market share. That said, these risks may moderate over time as Joe Biden's election victory has increased the prospect of a more dovish US approach to foreign policy and improving relations with China.

China's equity valuations should benefit from the impact of supply side reforms and stronger economy wide ROE

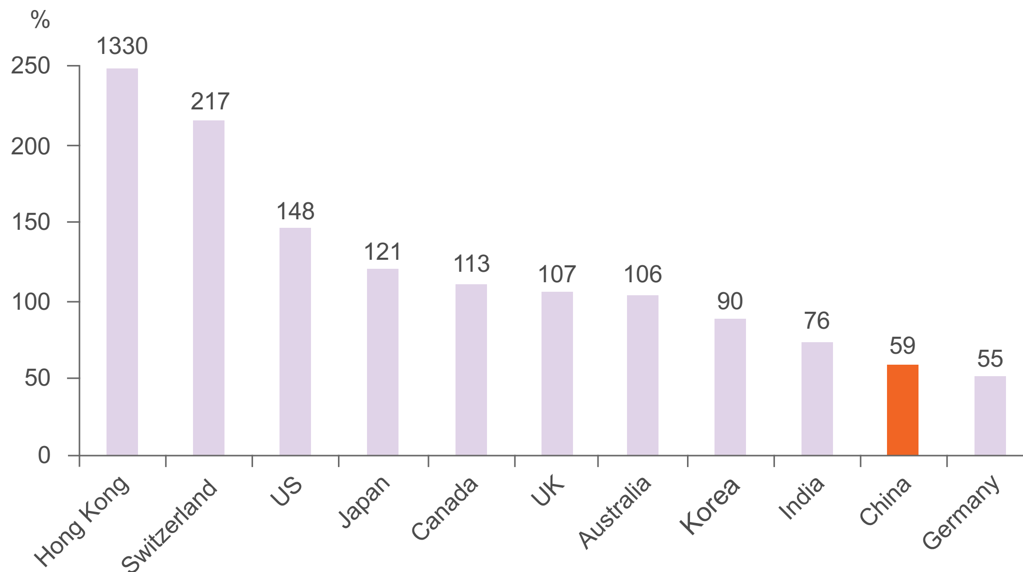
China's equities are driven by more than just GDP growth

There is a common misconception that China's equity returns are only high when its GDP growth is accelerating. However, China has managed to sustain solid equity returns even when its GDP growth has slowed significantly. Over the last 10 years, China's real GDP growth has fallen from 10.6% to 6% p.a. yet its MSCI index equity returns averaged 5.5% p.a. according to Refinitiv Datastream.

In theory, equity market performance is influenced by much more than just GDP. Earnings growth, tax regimes, valuation, liquidity, and sentiment, are all critical drivers of equity returns.

Part of the reason GDP growth is not such a critical driver of equity returns in China may be because equity market cap (at 59%) is only a modest share of the economy (in contrast to many other economies. See Figure 12). GDP growth may not become an important driver of China's equity market returns until the share market becomes a much larger component of the economy. Another interpretation is that China's equity market has significant upside longer-term for investors as its market cap grows and catches up to other economies.

Figure 12: Global equity market cap to GDP (%)



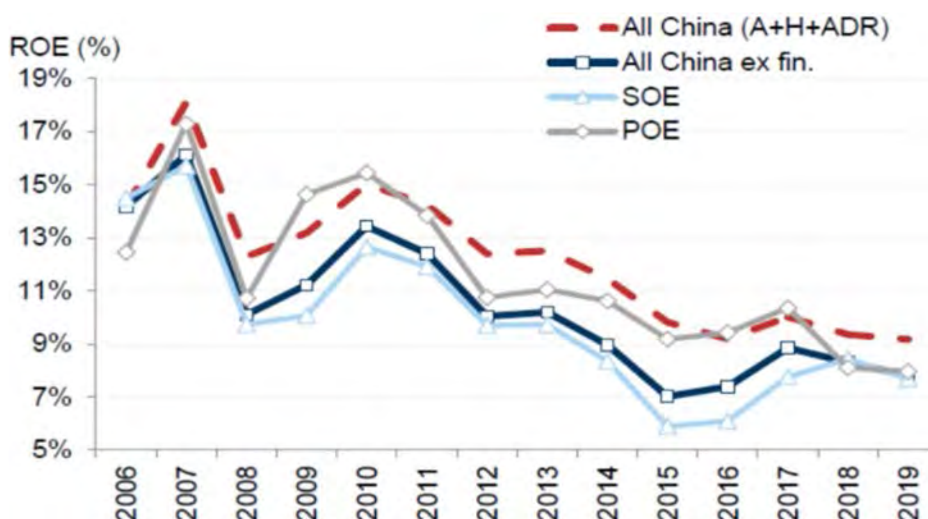
Source: JPM 31 July 2020

Economy wide ROE is also important in driving equity returns: China's reforms and 'new economy' growth should help boost ROE over time

While China's equities have sustained reasonable returns over time – notably outperforming returns from MSCI EM - they have still faced headwinds; in particular from the performance of some State Owned Enterprises (SOE) struggling to improve their profitability.

Notwithstanding that private sector ROE has slipped over the last 2-3 years, Figure 13 shows that the ROE for SOEs has rebounded from 2015-16 lows as China's supply side reforms have lowered overcapacity.

Figure 13: ROE from China SOEs, private firms, and aggregate equities



Source: Goldman Sachs 28 October 2020

Other targeted industrial policies (such as the Made in China 2025 plan) have also boosted optimism of better performance to come through. In addition, as the weight and performance of the new economy sectors continues to improve over time, we expect China's economy wide average ROE to also increase.

With the COVID-19 driven recession, the default rate for SOEs has also increased significantly. Although defaults can be a painful experience for impacted investors, allowing the most inefficient SOEs to fail will further remove overcapacity from the industry and help profitability to continue to improve.

How can investors reap the benefit of the ESG transformation taking place in China?

ESG in China – where do we stand today?

Corporate ESG management and reporting in China is known for being limited, fragmented and inconsistent. Practitioners point to the vagueness of corporate sustainability related commitments, solely qualitative nature of ESG reporting and lack of quantitative ESG data, metrics and KPIs.

This gap takes root in the breakneck economic development of the last 30 years that has focused on heavy industries, infrastructure and exports, which has pushed environmental and social considerations into the background.

In addition, the corporate landscape in China has been dominated by SOEs and family-owned businesses, both placing ESG standards at the bottom of their agenda and ESG-minded investors at the bottom of their hierarchy of stakeholders.

Nevertheless, this corporate landscape is rapidly evolving due to the convergence of several factors, including:

- **A macro-economic and societal shift from the 'old economy' to the new economy:** Compared to the heavily polluting companies of the old economy (oil & gas, power, mining), companies in the new economy tend to have a lower exposure to ESG risks due to the very nature of their business model (i.e. based on services and digitalisation). Corporates from the new economy also fiercely compete with each other to cater to the needs of a growing middle-class where Millennials - particularly young female consumers - are more aware of sustainable consumption behaviour.

- **An increasing pressure from the government to tackle issues such as climate change, air and water pollution**: though the largest greenhouse gases (GHG) emitter globally, China has signed the Paris Agreement and is now piloting carbon emissions trading schemes in 13 cities (that represent 5% of the global GHG emissions[6]). China aims to peak its carbon emissions by 2030 and to reduce carbon emissions per unit of GDP by 60% by 2030 from 2005 levels[7]. As a result, China has stronger ESG fundamentals relative to many EM.

- **A proliferation of soft ESG related regulations**: China has about a dozen ESG reporting guidelines from both government agencies and financial regulators (including the CSRC's Corporate Governance Code). This proliferation is connected to China's efforts to attract more foreign institutional investors into the domestic share market.

- **The emergence of Chinese global corporate leaders**: Chinese companies with dual listings in Hong Kong and in overseas exchanges have to comply with international governance standards and to align their ESG management systems with their European and North American peers.

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[6] Source: China: ESG with Chinese characteristics, IPE, September 2020.
https://www.ipe.com/reports/china-esg-with-chinese-characteristics/10047485.article
[7] Source: How does China's 2060 carbon neutral target impact financial markets? Responsible Investor, October 2020.
https://www.responsible-investor.com/articles/how-does-china-s-2060-carbon-neutral-target-impact-financial-markets

As a result of all these trends, ESG management and reporting in China is improving:

Figure 14: Country ESG Risk Scores

Source: Sustainalytics from Oct 2020

According to a study issued by the Chinese insurance company Ping Ang, in 2019 26% of all A-share companies issued a Sustainability report with the reporting-rate exceeding 80% for the CSI 300 (an A-share index designed to replicate the performance of the top 300 stocks traded on the Shanghai and Shenzhen exchanges), up from 54% in 2013[8].

[8] Source: How Chinese ESG disclosure can catch up with developed markets, Responsible Investor, September 2020, https://www.responsible-investor.com/articles/how-chinese-esg-disclosure-can-catch-up-with-developed-markets

What are the implications of this ESG transformation in China?

It is our opinion that Chinese companies that can sustain higher ESG standards are more likely to be rewarded by capital markets. As a matter of fact, over the last 7 years China's ESG and climate-based indices have outperformed their MSCI parent indices with similar risk level (i.e volatility. See Figure 15).

Figure 15: China ESG-linked returns & volatility versus aggregate indices

	MSCI China Index	MSCI China ESG Universal Index	MSCI China ESG Leaders Index	MSCI China Climate Change Index	MSCI China Low Carbon Leaders Index
Total return* (%)	8.4	9.2	14.3	8.8	8.7
Total risk (%)	20.4	20.4	21.0	20.8	20.9

Source: MSCI 16 September 2020. * Gross returns annualised in USD. Period: Nov 29, 2013 to Jul 31, 2020. The MSCI China ESG Universal Index gives more weight to companies demonstrating both a robust ESG profile, as well as a positive trend in improving that profile. The MSCI China ESG Leaders Index aims to provide exposure to companies with high ESG performance relative to their sector peers. The MSCI China Climate Change Index aims to represent the performance of an investment strategy that re-weights securities based upon the opportunities and risks associated with the transition to a lower carbon economy. The MSCI China Low Carbon Leaders Index tries to minimise exposures to carbon risk (by excluding companies with the highest carbon emissions and largest owners of carbon reserves).

With this steady improvement in ESG management and reporting, there are more opportunities for ESG-minded investors to gain exposure to Chinese companies with strong ESG fundamentals.

That said, this still requires ESG investment professionals with Mandarin language skills and local market expertise. ESG-conscious active fund managers focusing on China should be well positioned to support such investors in their quest for Chinese ESG-aligned stocks.

Active management also allows investors to get exposure to A-shares with solid ESG credentials that are not included in global benchmark indices yet. Systematically embedding ESG factors in equity research, and actively engaging with company management on ESG issues allows active fund managers to identify companies with strong track records in managing ESG risks and opportunities.

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