Promising China A-shares need to be on every institutional investors agenda

BY JOLANDA DE GROOT

China's economic (and financial) growth has been extraordinary not only over the last decade, but over the last 40+ years. Besides being the second largest economy in the world, it also hosts the second largest stock market. Access to this domestic part of the market (A-Shares) was difficult and limited until recently. With reforms on access and trading, China has opened up this important part of its economy and the financial market to more foreign investors. Dr. Cord Hinrichs, Head of Asset Allocation at Corestone Investment Managers AG, on investing in the 'Middle Empire'.

Looking at the current index composition, of MSCI or FTSE, it becomes clear that current index weightings of China (H- and A-Shares) do not reflect either the size of China's economy nor the size and opportunity set of the stock market. This is changing with MSCI moving forward in including more A-Shares into their indices (going from currently 5% to 20% inclusion factor by November) and FTSE also introducing A-Shares into their indices.

There has been significant growth in the adoption of A-share investments by international investors as the number of northbound Stock Connect accounts has grown from 1,700 before the June 2017 inclusion announcement to over 7,300 in February 2019. Assets have grown 160% despite negative returns for the index over that time frame.

Institutional investors are, given current index compositions, substantially underweight China in relation to its economic and financial importance.

With the ongoing inclusion of A-Shares into standard benchmark indices, investors will need to cope with and understand this new market segment to better comprehend the potential and risks which arise.

How far and fast will the inclusion go? How quickly will investors have to deal with a significant part of their portfolio being in a market segment they have only limited knowledge about?

Looking at South Korea and Taiwan as examples of countries which went through the same process and took 6 and 9 years, respectively, to win full inclusion from an initial 20%, and given China's economic importance, we are convinced that full inclusion – which is our base case scenario – will happen within the next 4-5 years. Given this outlook, investors need to start looking at ways to access and more importantly also understand the A-Share market sooner rather than later.

How can investors benefit from this development?

With the Stock Connect, access to A-Shares is available and is continuously growing in terms of tradeable stocks. To benefit from the structural change in the global financial market landscape with the opening of the A-Share market, investors should start analyzing and also start investing in A-Shares not just in line with the inclusion factor but ahead of the curve. The opportunity set in China A-Shares is substantial and the earlier investors get familiar with this market and its peculiarities the better. History has shown that markets move substantially before an index change. For example, Portugal when it was promoted from Emerging Market to Developed Market status in 1997, its index rallied more than 100% in 2 years before that while the MSCI World made only 26%.

But even if investors only start to access China A-Shares slowly and in line with the inclusion factor, the structural return opportunities in this market over the long-term are substantial and need to be on the agenda of every pension fund and institutional investor.

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How do institutional investors best gain access to this market segment?

The easiest way nowadays is via the Stock Connect, the trading channel which connects Hong Kong with the two exchanges in Shanghai and Shenzhen. This channel has evolved since its opening in 2014 and is today the most cost-efficient way to access A-Shares. Currently, not all stocks are accessible, but this will change in the coming quarters and years and a much wider spectrum of stocks will be available for international investors until eventually full inclusion and further market liberalization in terms of access is reached.

On the implementation side, passive is not our preferred option. Passive funds for China A-Shares are still expensive, underperform their respective indices and additionally experience substantial tracking errors due to the underlying characteristics of the A-Share market. Hence, investors pay almost active fees for continuous underperformance.

From our point of view, fundamental managers and since recently also a few quant managers offer much more value in terms of excess returns for their costs. However, finding the right mix of managers which fit the mindset and requirements of international investors to achieve superior returns while keeping a close eye on the risks is not easy and in-depth knowledge of the market is necessary which we were luckily able to build over the last decade.

What are the main risks on the financial side and on the economic side?

However high the potential in China A-Shares, the risks that investors must understand and assess are also substantial. This market is very different from what the vast majority of international investors are used to. Trading suspensions, daily price limits, extremely high trading turnover of over 250% annually, retail-driven, irrational and fast sector rotations are only a few things investors need to understand besides deeply rooted cultural and linguistic differences. A thorough understanding of the market, its mechanism and nature, is essential. Not only to achieve superior returns, but also to keep the underlying risks in check.

Additionally, governmental control and possible changes in regulation need to be kept in mind when looking at China. After all, it is still a centrally controlled economy.

China A-Shares is not an easy market to invest in, but from our experience, travels throughout China and meetings with managers, government officials and companies over the years, the long-term prospects make it more than worthwhile to take a much closer look at the market, starting now.

What is the road ahead for China in major benchmark indices? Will there be a MSCI EM ex China index, like the MSCI Asia ex Japan index we have today?

As said, we reckon full inclusion of China A-Shares into the MSCI index family as well as into FTSE Russell, is only a matter of time. Once full inclusion is reached, we are talking about 45% to 50% of the Emerging Market Index being China A & H. Then, in our opinion it becomes a necessity to have a split of the Emerging Market index into MSCI EM and MSCI EM ex China. This way, the second largest equity market in the world can be accessed in a more isolated and targeted way and exposure to the remaining Emerging Markets in the index becomes more balanced with the index heavyweight «

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Dr. Hinrichs joined Corestone in 2016 to head up the Asset Allocation team. In his role among other things he is responsible for managing discretionary private client portfolios and identifying structural shifts in financial markets and new asset classes for Corestone's client portfolios overall. Prior to that, Hinrichs worked for Suva, the Swiss National Accident Insurance Institution, a 45bn € institution, in various functions over time, as Lead Economist, Portfolio Manager and creator of the Systematic TAA and Portfolio Manager for external manager selection where he was instrumental in setting up and successfully managing the China A portfolio.