

JULY 2018

## CHINA A SHARES – THE EMERGING MARKET OF THE 21<sup>ST</sup> CENTURY

### Overview

China's onshore equity market is the second largest in the world by market capitalisation, yet to date, various issues have resulted in low foreign investor participation. JANA's Global Equity Research Team conducted a research trip in April to Shanghai, Shenzhen, Hong Kong and Singapore, focusing on the following broad investment themes:

- > The implications of MSCI's inclusion of China A shares in its flagship indices this year;
- > Access to China's onshore equity markets; and
- > Fund managers approaches to investing in China.

During this research trip, JANA met with a range of local and foreign fund managers, including Joint Ventures (JVs) and Wholly Foreign Owned Enterprises (WFOEs). We also met representatives of the Shanghai Stock Exchange and joined fund managers for company visits in Shenzhen and Hong Kong. Based on the research conducted, JANA believes that it has useful insights on how to best structure an investment into the China A share market, which is likely to be the emerging market of the 21st century.

### Chinese Equity Markets

Foreign investors have historically encountered various restrictions in accessing China's onshore equity markets. As a result of these restrictions, various distinct share classes have arisen based on where a Chinese company is incorporated, its country of listing and the trading currency used. The following table provides a brief overview of the differences between these share classes.

	Share Class	Incorporation and Listing	Trading Currency
<b>Onshore equities</b>	<b>A shares</b>	Companies incorporated and listed in mainland China	RMB
	<b>B shares</b>	Companies incorporated and listed in mainland China	USD (Shanghai SE) HKD (Shenzhen SE)
<b>Offshore equities</b>	<b>H shares</b>	Companies incorporated in mainland China and listed in Hong Kong	HKD
	<b>Red chips</b>	State-owned Chinese companies incorporated outside mainland China and listed in Hong Kong	HKD
	<b>P chips</b>	Non-state-owned Chinese companies incorporated outside mainland China and listed in Hong Kong	HKD
	<b>Overseas-listed</b>	American Depositary Receipts (ADRs) and Chinese companies incorporated outside mainland China that are listed overseas (S chips listed in Singapore and N shares listed in New York)	SGD (S chips) USD (N shares/ADRs)



**Bill Dwyer**  
– Senior  
Consultant

Bill is a Senior Consultant and member of the Global Equities

Research Team.

Prior to joining JANA, Bill was Head of Investments at Government Employees Superannuation Board (GESB) where he oversaw the investment team and was responsible for the management of the investment portfolio. He was previously Manager, Investments at Non-Government Schools Superannuation Fund (NGS Super).

Bill holds a Bachelor of Commerce (First Class Honours) degree, is a CFA Charterholder and an Actuary with leadership and investment training from Columbia Business School.



**Raymond Lam**  
– Consultant

Raymond is a Consultant and member of the Global Equities

Research Team.

Prior to joining JANA in 2016, Raymond spent eight years working in the private banking industry; providing banking, financing and investment solutions to high net worth individuals.

Raymond holds Bachelor of Commerce (Finance & Economics) and Bachelor of Arts (Psychology & Politics) degrees from the University of NSW and a Diploma of Financial Planning.

Given recent developments that have improved investor accessibility to China's onshore A share market, JANA recommends utilising both onshore and offshore channels to capture the broadest equity opportunity set for China. This unified 'All China' approach deconstructs the separate share classes that have arisen due to the distinct nature of China's market liberalisation path and instead allows investing across the broad opportunity set whilst being agnostic to access channels.

## A Shares – The emerging market

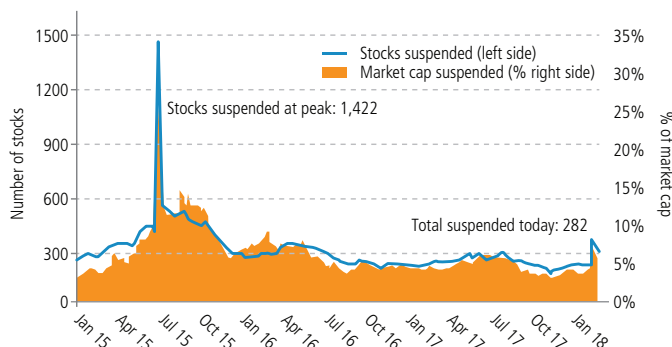
### China A share market – key milestones for foreign investors



Chinese offshore equities have traditionally been favoured by foreign investors seeking to gain exposure to Chinese equities. However more recent developments have addressed some of the historical impediments to investing in China's onshore A share market:

- Access: the introduction of the Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect trading links in November 2014 and December 2016 provided an alternative access channel to sidestep the onerous regulatory approval requirements and usage conditions of the QFII/RQFII schemes historically required by foreign investors to access China's onshore A-share market;
- Relevance: MSCI's decision to include China A-shares in its widely followed Emerging Markets index this year has associated implications for benchmark-aware investors. Whilst the initial 5% inclusion factor of A-shares only accounts for approximately 0.8% of the index, it represents a symbolic milestone in the internationalisation of China's financial markets;
- Governance: Foreign investors have long held concerns around the underlying transparency and governance of companies listed on China's onshore stock markets; in particular the prevalence and extended duration of stock suspensions which affects liquidity and information transparency. During the height of China's 2015 stock market crash, half of China's domestic listed stocks were suspended. The China Securities Regulatory Commission (CSRC) has subsequently applied more stringent rules on stock trading suspensions whilst Chinese companies are progressively improving their engagement with foreign investors.

Chart 1 – Stock Suspensions

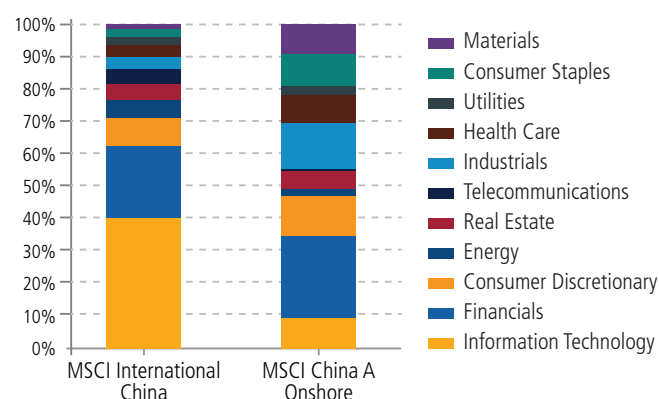


Source: Allianz Global Investors, Wind, Goldman Sachs Global Investment Research  
– as at 23 Feb 2018

### Diversification

The addition of A shares to the Chinese equity opportunity set provides additional diversification benefits as illustrated in Chart 2. The MSCI International China index represents the traditional offshore markets accessed by foreign investors, whilst the MSCI China A Onshore Index represents China's domestic market<sup>1</sup>. There is an evident skew towards the IT sector within the International China index, reflecting a large weighting towards the 'BAT' IT stocks (Baidu, Alibaba and Tencent). Notwithstanding the large weighting towards the Financials sector, the China A onshore index is more broadly diversified across sectors and has greater exposure to the Consumer Discretionary and Health Care sectors which are integral to the Chinese consumer theme.

Chart 2 – GICS Sector Weights



Source: MSCI – 31 May 2018

Including access to onshore A share stocks is expected to increase the breadth of investment opportunities that can leverage structural trends and characteristics specific to China.

<sup>1</sup> The MSCI International China index captures large and mid-cap representation across Chinese securities traditionally accessed by foreign investors (i.e. H shares, B shares, Red chips, P chips and ADRs), whilst the MSCI China A Onshore index captures large and mid-cap representation across Chinese A share securities listed on the domestic Shanghai and Shenzhen stock exchanges.

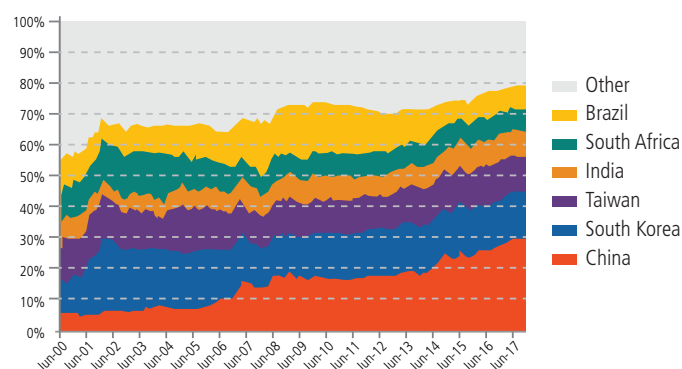
Examples of prominent China A share stocks held by foreign investors include:

- Hangzhou Hikvision (video surveillance products): which has been provided innovation opportunities and enormous scale in a country where privacy expectations are lower compared to Western countries;
- Midea Group (household electrical appliances): leveraging the Chinese consumer upgrade trend, with increasing incomes and generational changes in consumption patterns promoting increasing discretionary spending; and
- Zhengzhou Yutong (manufacturer and distributor of electric buses): aligning with China's strategy to move up the manufacturing value-chain, with the Made in China 2025 roadmap to becoming a dominant power across 10 high-tech industries including new-energy vehicles.

## Index implications

The main implication of China being a large part of MSCI's Emerging Markets index is that this index will become increasingly driven by the returns of Chinese companies. As can be seen in Chart 3, the Emerging Markets index already comprises around a 31% exposure to Chinese companies, and this exposure has increased significantly over the past eighteen years.

Chart 3 – MSCI Emerging Markets Index

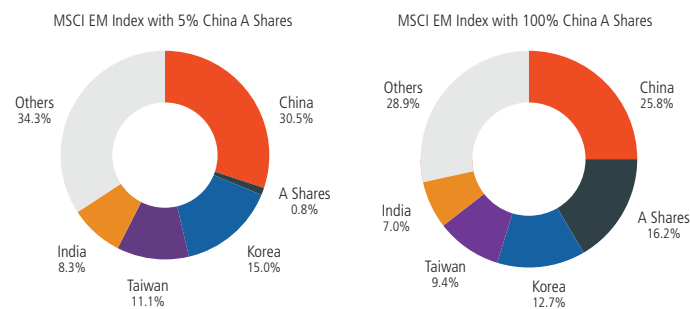


Source: FactSet, June 2000 – May 2018

Whilst there is now a small weighting to the China A share market based on MSCI's initial 5% inclusion factor as shown in Chart 4, the vast majority of Chinese companies in the Emerging Markets index are still listed on China's offshore equities markets. In the event of full inclusion of China A shares in the index (i.e. 100% inclusion factor), MSCI projects Chinese equities would represent 42% of the Emerging Markets index, with around 40% of these stocks listed in the China A share market.

In order to attain a 100% inclusion factor over time, China will need to continue making progress in improving foreign accessibility to its domestic markets and managing the prevalence and duration of trading suspensions.

Chart 4 – Projected Index Weighting

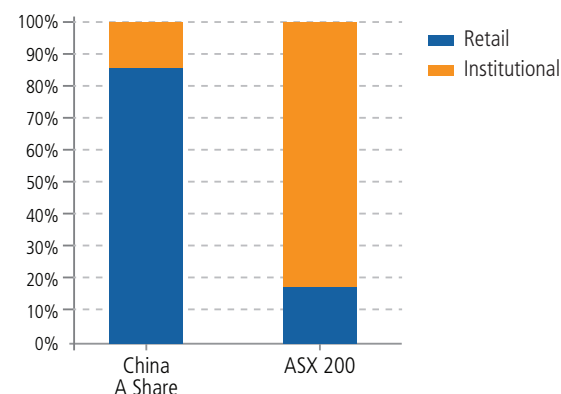


Source: MSCI – based on current market capitalisation

## Investing in China A shares

The current dominance of retail investors trading in the China A share market as shown in Chart 5, results in a highly volatile market that is subject to short holding periods and high turnover. This is in contrast with the Australian share market, where institutional investors comprise the vast majority of trading volume. The alpha opportunity for actively managed strategies could be a valuable complement to the volatile beta within this highly inefficient market although, over time, as the market matures this degree of inefficiency may moderate.

Chart 5 – Retail vs. Institutional Trading Volumes



Source: UBS, SSE, CLSA, ASX

Given the size and idiosyncrasies of the Chinese equity market, JANA considers 'China specialists' (i.e. analysts with an overarching focus on the Chinese market) to be a valuable resource to any investment team covering this universe. JANA believes on the ground experience is a competitive edge for discretionary investment managers to gauge the pulse of regulatory developments in a market which is prone to State intervention.

Adequate local language skills (i.e. Mandarin Chinese) are recommended, given differences between Chinese and English-translated company and research reports, in addition to Mandarin being the preferred language for management teams and in conducting channel checks.

Whilst domestic fund managers may possess advantages with respect to local insights and on-the-ground resourcing, China's institutional investment profession is less mature compared to global counterparts and represents a smaller proportion of trading volume in this market. JANA believes potential risks within domestic fund managers are the prevalence of retail-oriented investment philosophies, a large emphasis on short-term peer-relative performance and less developed risk controls.

There may be valid opportunities to engage with the more established domestic fund managers but there is a need for more comprehensive due diligence and proper consideration of which client segment the manager is predominantly catering towards (e.g. local retail investors or institutions) in making an assessment of the fund manager.

For foreign fund managers, adequate and specialised coverage are key to leveraging investment opportunities in China's vast onshore market. Large foreign firms have typically gone down the route of forming JVs with domestic Chinese managers or alternatively setting up a WFOE (a limited liability company wholly owned by a foreign entity) in China.

JANA's preference is for WFOEs given the manager has more autonomy and direct control over both the investment process and personnel, although ensuring the venture is adequately resourced with critical mass is a key consideration.

JANA does not rule out the feasibility of JVs but the calibre of the local Chinese partner and the working relationship between the two parties are critical to achieving success.

## Conclusion

JANA's research trip was extremely valuable in providing broad based validation of the thesis that investment in Chinese A shares is an opportunity that needs to be taken seriously. Chinese equities will dominate the Emerging Markets index in the not too distant future and A shares are an important component of the Chinese equity market, providing important diversification beyond the IT stocks that dominate the Chinese offshore market.

The historical barriers to entry into the Chinese onshore market have dissipated to a large extent, with residual structural market issues to be progressively resolved. Whilst there are various avenues to invest in the China A share market through fund managers, local knowledge and 'on the ground' research combined with strong due diligence are critical in selecting the appropriate method to gain access to the emerging market of the 21st century.

### Disclaimer: This material is not for circulation to retail investors

*This information is provided by JANA Investment Advisers Pty Ltd (ABN 97 006 717 568, AFSL 230693) ("JANA IA"), Level 6, 255 George St, Sydney 2000. This document may not be copied or redistributed without the prior consent of JANA IA. This document is intended for use only by persons who are 'wholesale clients' within the meaning of the Corporations Act. The information is directed to and prepared for Australian residents only. Returns are not guaranteed and actual returns may vary from the returns discussed in this communication. Securities mentioned in this article may no longer be recommended by JANA IA. Any service or investment referred to in this communication is not a deposit with or liability of, and is not guaranteed by, JANA IA.*

*While due care has been taken in the preparation of this document, no warranty is given as to the accuracy of the information. Except where under statute liability cannot be excluded, no liability (whether arising in negligence or otherwise) is accepted by JANA IA for any error or omission or for any loss caused to any person acting on the information contained in this document. A137246-0717*