The Case for China

Participating in the growth of the world's second largest economy

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More information?

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1 Executive summary

Why invest in China?

The potential to participate in Chinese growth is an unprecedented opportunity for any global investor:

- China is **too large to ignore**: the world's second largest stock market with more than 4,000 companies on the mainland (A-shares) and 1,500 listed in Hong Kong and elsewhere
- Mainland companies have a market capitalisation of about US$ 9 trillion but are **underrepresented in global indices** such as the MSCI Global Emerging Markets equity index. China is around 20% of global market cap but less than 3% of global portfolios.
- The universe has some of the world's **largest, most innovative and fastest growing companies**, like Alibaba and Tencent and even more interestingly many domestic companies – largely unknown to western observers – providing products and services to local consumers.
- **Growth potential continues to be compelling** – China dealt with COVID-19 better than most countries and GDP growth forecasts continue to be in excess of 6% p.a. even in a world of slower overall economic growth. More importantly the growth drivers are now broad-based as the world's largest population matures, urbanises, embraces technology and e-commerce and so on. Additionally, state support through fiscal packages and poverty reduction schemes provides a material tailwind.
- The Chinese **equity market is under researched and dominated by retail investor activity**; this creates a handsome opportunity for **active management**.
- Chinese equities have **very low correlation** with developed and other emerging markets. Global investors can capture the benefit of diversification by making a dedicated allocation to Chinese equities.

How to invest in China

Accessing the market itself has become considerably easier thanks to the introduction and expansion of the Stock Connect Programme, which has all but replaced the earlier, cumbersome, and restrictive quota-based access mechanism.

- The **Stock Connect** programme provides foreign investors easy access to onshore equities – this was not the case 10 years ago. Since launch, foreign inflows have increased substantially.

Allocating to China means selecting one or more suitable investment managers with sufficient local expertise. The asset management industry that specialises in China can be split into two 'heritages':

- **Global asset managers** that have invested in Asia including (offshore/HK) China for many years but are still relatively new to mainland China and face substantial upskilling due various factors like the sheer volume of mainland Chinese companies, language barriers or different accounting standards, and limited broker research coverage
- **Chinese specialist asset managers, typically based on the mainland**; until recently these have not been of institutional quality but instead tailored towards a retail client base

Both groups have advantages and disadvantages: an experienced, proven processes but continued unfamiliarity on the one hand versus nascent talent and processes paired with likely superior local knowledge on the other.

A **well-constructed China allocation** would seek to **draw on both heritages**.

Another phenomenon of the Chinese specialists is an **intense sector or regional focus**. Very concentrated portfolios – with resulting higher levels of volatility – are common. Successful managers exhibit periods of significant underperformance on the road to eventual superior outcomes.

Given this concentration, we consider it imprudent to allocate to only one or two specialist managers. Add to this a relatively new industry where it is not yet clear who winners and losers will be, then it is clear that **diversification of managers is critical**. Having multiple managers additionally helps capture growth opportunities across a wider breadth. A multi-manager allocation will deliver better risk-adjusted returns than trying to select the top performing single manager.

What to look out for when investing in China

This is a new market; companies are new and so is the asset management industry. The opportunity set has evolved rapidly and continues to change. **Nimbleness may be necessary** to respond to quickly developing regulatory, market or manager issues.

Investing in China to capture the extraordinary alpha opportunity is **time sensitive**. Prices and the mechanism for price discovery will be impacted as flows from foreign investors increase, bringing with them more rigorous analysis and portfolio management techniques.

A dedicated partner is necessary

Manager selection in China will be **more complex** than elsewhere. Data is more difficult to obtain, managers are selective about clients, information is not standardised, and opportunities are very dynamic. Unless an asset allocator is prepared to staff up a sufficient China manager research capability, **partnering with a dedicated selection specialist is essential**.

2 About RisCura

RisCura is a purpose-driven global investment firm that offers investors unique insights and guidance to mitigate, adapt and invest for a world we all want to live in. RisCura is known for its leading focus on transparency, performance standards, ethical investment strategies, independent risk assessments and world-class independent valuations that has brought about a systemic shift in the emerging market investment landscape. With our emerging and frontier market specialist capabilities, we aim to assist investors with access to some of the fastest growing economies in the world. We help with macro views, asset allocation, and source and put together portfolios of highly talented investment managers. Over the last three years, RisCura has also developed specialist capabilities in the China market that has brought about new investment opportunities for clients.

Today RisCura advises clients with combined assets of more than $200bn, $120bn of which are being remodelled by the RisCura team for greater transparency and ethical standards. The company strives to steer global investment capital towards investments that benefit society and the planet in the long run.

Our global footprint

$200BN UNDER ADVICE | **OVER $1BN** ALLOCATED TO CHINA | **$800M** MULTI-MANAGER CHINA FUND | TRUSTED PARTNER TO STATE AND MULTINATIONAL SCHEMES

Source: Countries as categorized by MSCI

A selection of our clients

SELECTED PUBLIC SECTOR CLIENTS

- Government Employees Pension Fund South Africa
- Government Institutions Pension Fund Namibia
- Public Officers Pension Fund Botswana
- Tshwane Municipality South Africa
- National Student Financial Aid Scheme South Africa

SELECTED INDUSTRY SCHEMES

- Sentinel (orig. Mineworkers Union) South Africa
- Typographical Union South Africa
- Motor Industry South Africa

SELECTED CORPORATE FUNDS

- Telkom South Africa
- BMW South Africa
- Mercedes Benz South Africa
- DHL South Africa
- Total Oil South Africa
- Eskom South Africa

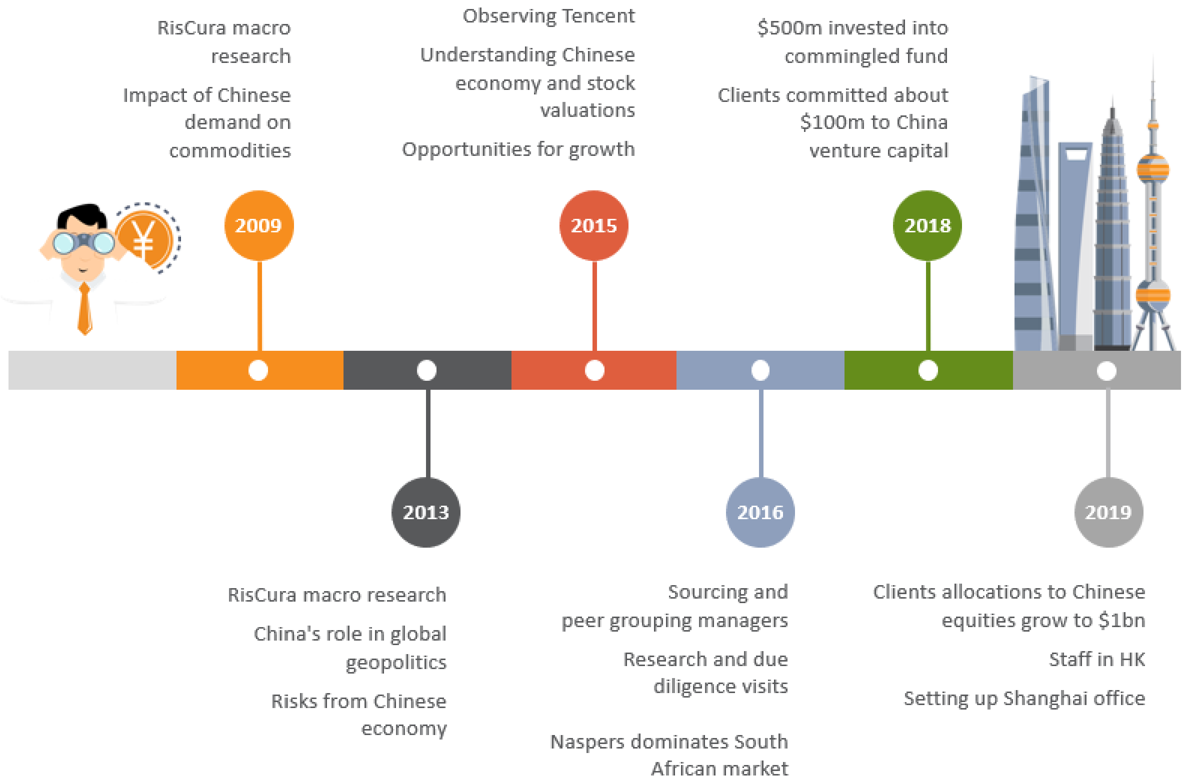
3 Introduction

RisCura has followed and researched the progress of mainland China and its investment opportunities for many years. China has been important for emerging market economies – like our home market of South Africa – due to its demand for natural resources. The original catalyst for understanding the asset management landscape was the (very successful) investment made by Naspers, a South African media company, into Tencent in the early 2000s. A $30m investment for just under half of Tencent subsequently grew into a multi-billion dollar holding, and with that Naspers grew to dominate the South African equity market. This required South African asset owners to form views on the Chinese economy not only as a consumer of South African raw materials but more importantly on what is happening inside China itself (given their substantial look-through exposure). Later, with benchmarks capping the weight of Naspers, the opportunity to replace resulting 'lost' single-stock Tencent/China exposure with a diversified portfolio prompted RisCura to engage in a comprehensive research and evaluation of the Chinese market and asset management landscape.

We have watched the evolution of the market and asset managers very closely over this time. Our conviction in the investment case became sufficiently strong that we have been advising our clients on making allocations to China since 2018, with over $1bn allocated to date.

This paper sets out our rationale for investing in China, describes the Chinese equity market, considers RisCura's approach to selecting investment managers and discusses options to implement an allocation within a global equity portfolio.

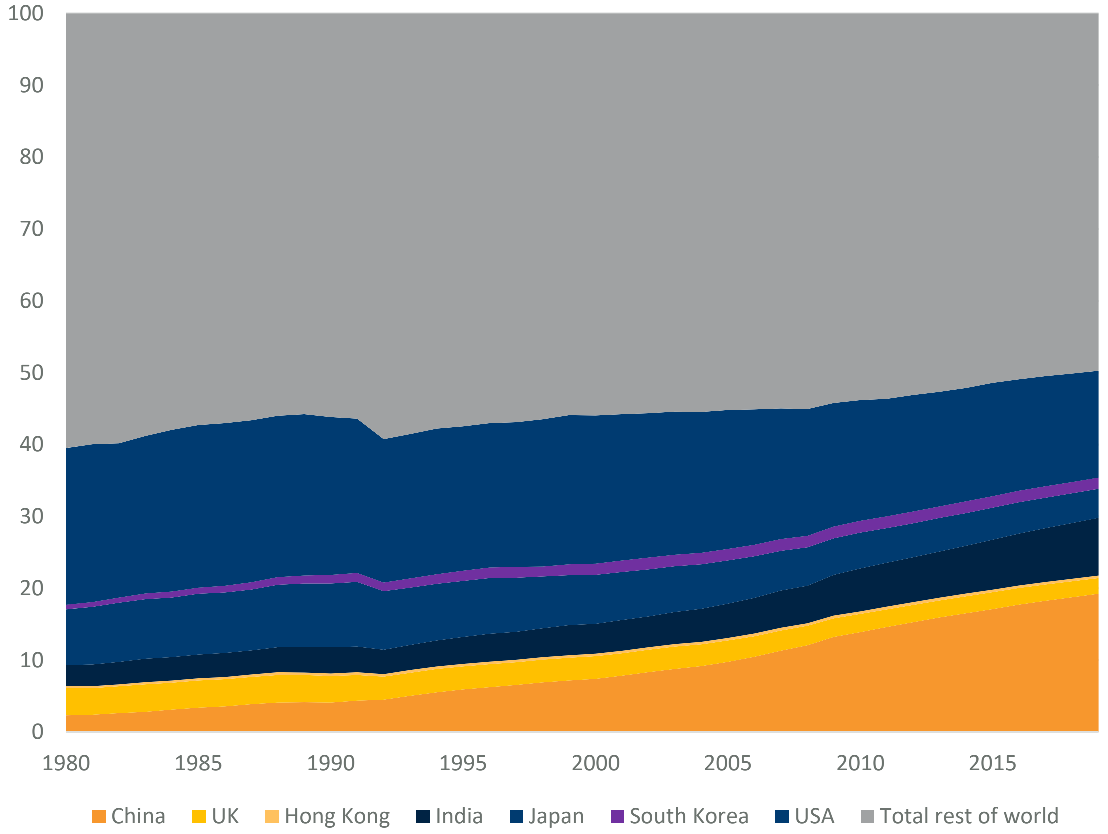
Our research focus has evolved over the years in tandem with the country, its economy and the investment opportunity set evolving. The following schematic demonstrates how our focus has changed:



4 The big picture

Putting China and its economy on the map

Chart 1: China's economy as a percentage of global GDP



Source: Lion Global Investors; World Bank; HSBC; purchasing power parity basis

China has progressed from contributing around 2% of global GDP in the early 1980s to almost 15%, resulting in it becoming a systemic component of the global economy beyond being a centre for low-cost production. At the same time, it has become increasingly mature internally and increasingly outward looking, both geo-politically and economically.

The internal spread of China's economy has often gone unnoticed by outsiders. For example, the population size and consequent economic output of many Chinese cities is comparable to the GDP of entire countries. And within that population, demand for consumer goods is skyrocketing.

Table 1 illustrates the size of some cities, many completely unfamiliar outside China[1].

Table 1: GDP of selected Chinese cities compared with entire countries

City	Population	GBP (US$)	GDP comparable to...
Shanghai	27m	454bn	Austria
Tianjin	13m	275bn	Finland
Nanjing	9m	174bn	Hungary
Beijing	20m	415bn	Norway
Guangzhou	13m	318bn	Bangladesh
Chengdu	9m	206bn	New Zealand
Chongqing	16m	288bn	Pakistan
Shenzhen	12m	342bn	Denmark
Wuhan	8m	199bn	Qatar

In addition, when measured on a GDP per capita basis, if the Chinese cities are able to match western levels their economic size could be larger by a multiple of current numbers.

Emerging and developed characteristics with multiple growth drivers

China has seen substantial growth thanks to 40 years of economic reform but its huge population size means it still shows comparatively low GDP / capita.

State control continues to be a key feature of its economy – which has both benefits and drawbacks – and the state operates with an "expansionist foreign policy". Unlike other emerging countries, China has a well-developed military and diplomatic presence which it is increasingly using across its neighbouring region. Through initiatives like the 'Belt-and-Road' programme, it has sought to expand its economic influence around the world.

Internally, China benefits from a first world infrastructure, often more developed than developed nations. It has technology leadership in some areas, especially telecoms and mobile connectivity. It is estimated that by the end of 2020 China will become only the second country after South Korea to cover all major cities with 5G phone networks.

Poverty reduction, environmental protection and systematic risk prevention are three primary goals for the Chinese government domestically. Following its supply-side reform in the real economy since 2015, a recent Politburo meeting called for a similar supply-side reform in the financial industry.

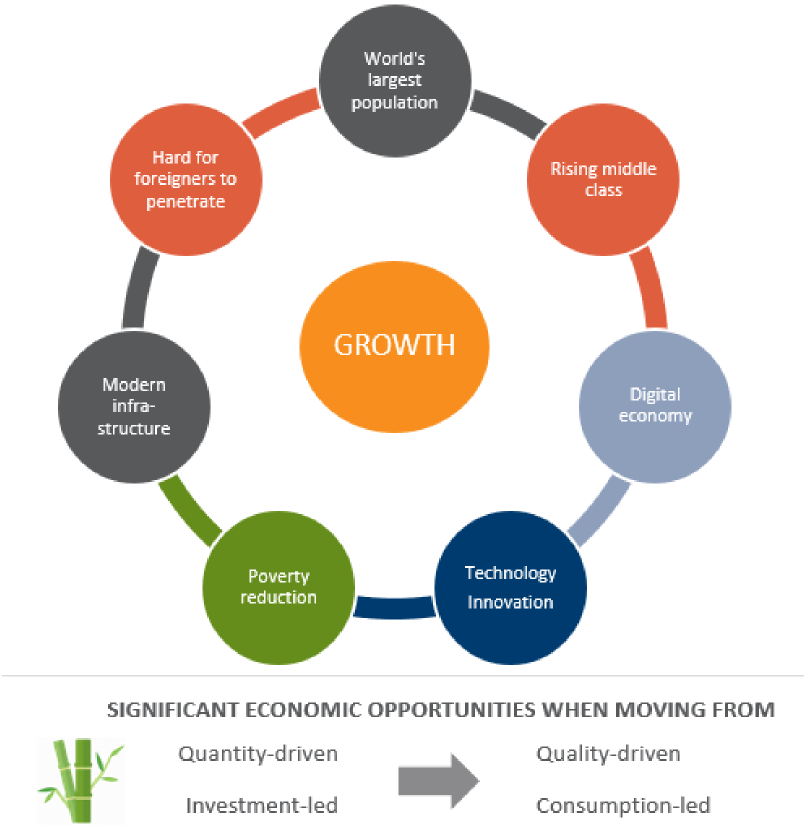
The new reforms will lift the role of the financial sector and herald a new relevance for the capital markets as a route for corporate financing (traditionally financing has been sourced through banks and peer-to-peer arrangements like unregulated "shadow banks"). It will expand the scale of direct financing and the build-up of a multi-layered financing system, designed to meet the financing needs of emerging industries and innovation-driven businesses.

Urbanisation, a modern infrastructure, a rising middle class, the digital economy, technological innovation: all are contributing to transitioning China's economy from a **quantity-driven** to **quality-driven** model.

[1] Data from Wikipedia/official estimates; IMF 2019 estimate for GDP

It is clear that multiple drivers for Chinese growth coupled with the world's largest population create an investment opportunity set that is broader than the headline-grabbing sectors such as technology and exports.

Chart 2: Multiple drivers for growth

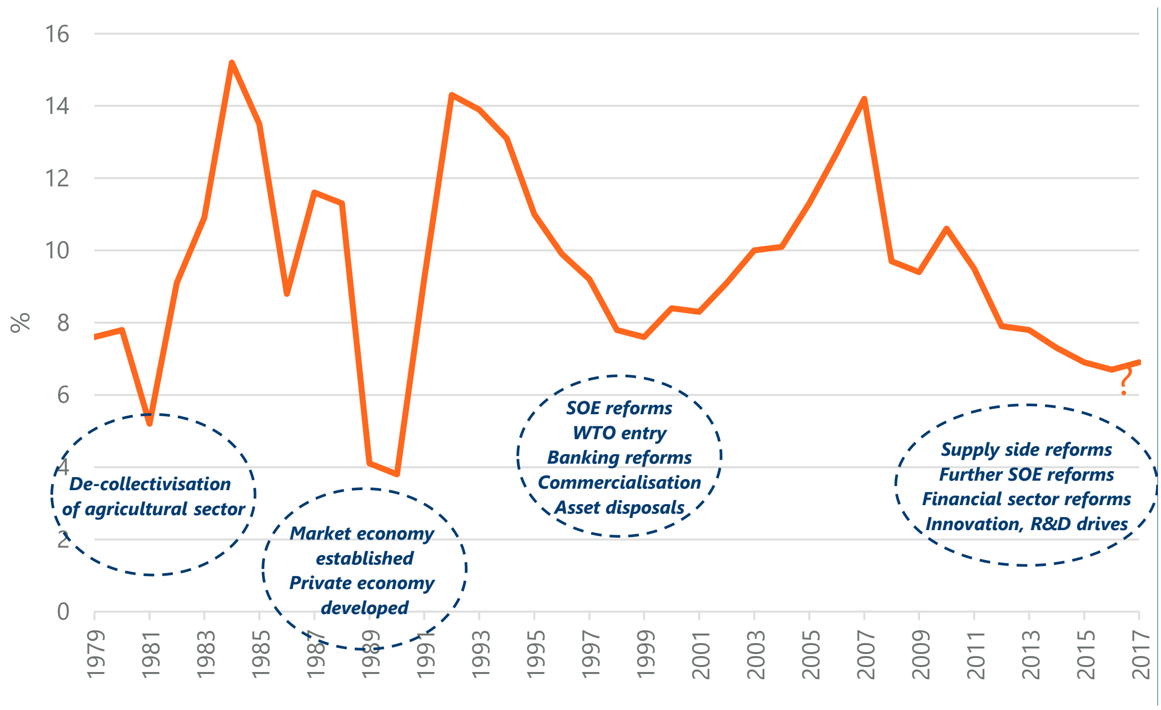


<u>**Observation:**</u>

When implementing a Chinese portfolio, a diversified portfolio across multiple sectors will capture a wider breadth of growth.

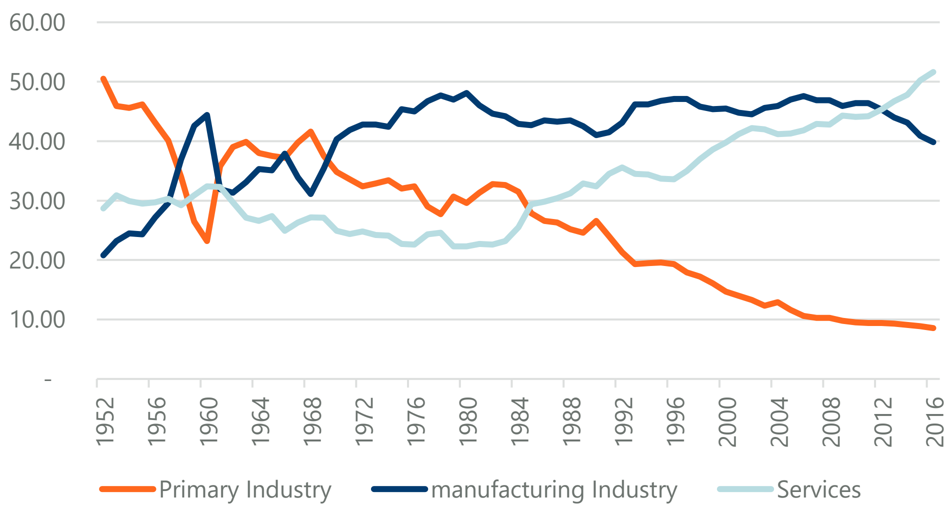
Furthermore, we would argue that China is in a "sweet spot" in its domestic political cycle. President Xi Jinping has a strong political mandate which can be used to drive reforms – including otherwise unpopular ones. History has shown that moments such as these, where meaningful reforms can be swiftly implemented, have led to strong growth as Chart 3 overleaf shows.

Chart 3: China real GDP growth (%) - Strong growth tends to follow reform



There is already evidence of this emerging growth driven by consumers as opposed to historical growth largely led by manufactured exports and government-led investment into infrastructure. As the economy matures, the proportion of GDP represented by agriculture and mining (primary industries) gives way to manufacturing (secondary industry) and in turn to services (tertiary industry). Services now account for more than half of the total economy.

Chart 4: Sectoral contribution to the Chinese economy



Source: Zeal China

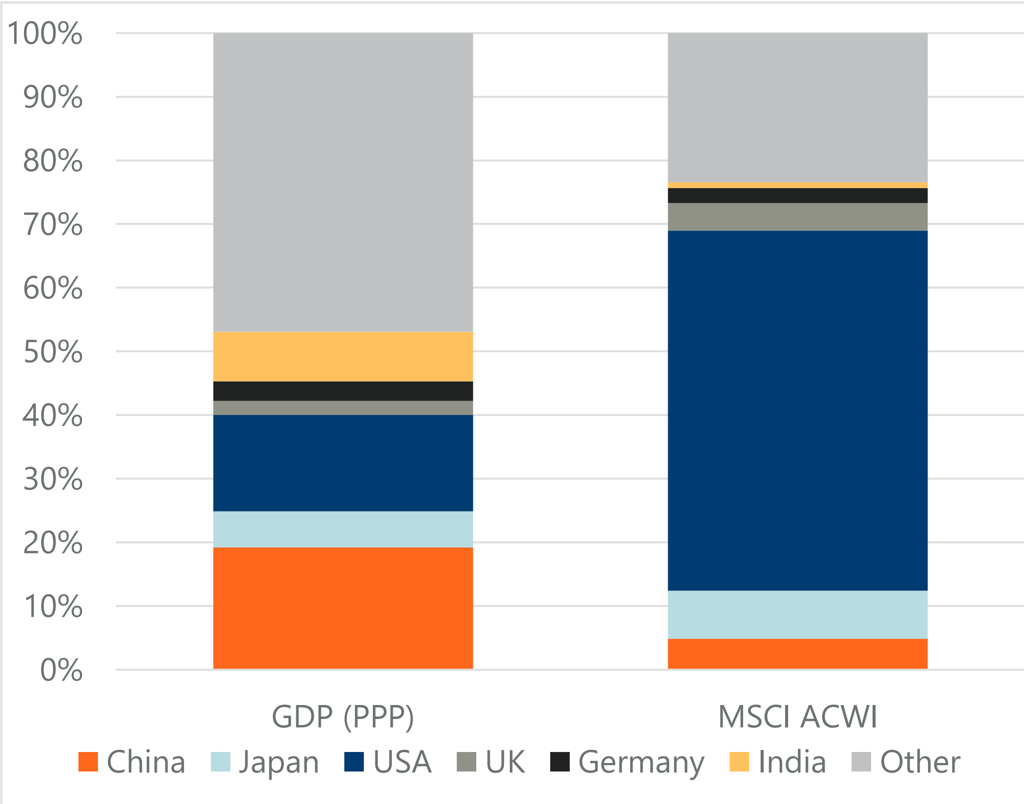
An infrastructure drive in the early 2000s depressed the share of GDP represented by household consumption however over the last 10 years this has reversed in tandem with the maturing of the economy.

What the charts indicate is that there has been a shift of growth towards consumption-led rather than investment-led, with the former mainly run by the private sector This results in opportunities for talented entrepreneurs to create businesses growing at a rapid pace and quickly reaching significant scale. We have found evidence of consumer-driven growth across a wide range of sectors ranging from furniture, fresh food retail to ecommerce and social media. Many of these companies are now listed on the mainland stock exchanges.

The Chinese stock market

While the Chinese economy has been growing strongly, until recently, regulatory and legal restrictions made it difficult for non-Chinese investors to gain access to most of the Chinese equity universe and participate in this growth. China's equity market is therefore significantly under-represented in global indices when compared to China's contribution to global GDP. This is illustrated in Chart 5.

Chart 5: China's representation in global indices and funds versus GDP

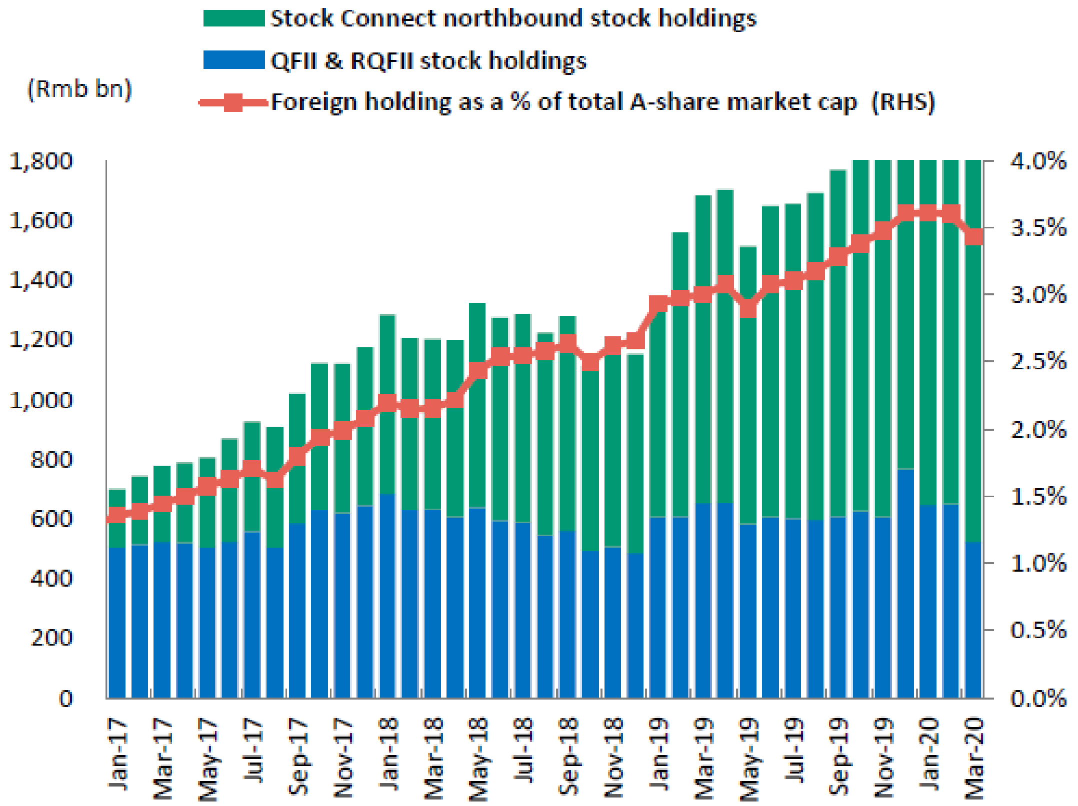


Source: IMF, WFE, EPRS, MSCI, HSBC Equity Strategy

In the past, access was largely limited to Chinese companies listed on 'global' stock markets (such as Hong Kong), or cumbersome entry through capital-controlled investment programmes (such as the Qualified Foreign Institutional Investor or QFII programme). However, a further manifestation of the outward-looking trend underway by the Chinese authorities is the opening up of its stock markets to foreign investors through initiatives like the Stock Connect system which started in 2014. This has significant implications as Stock Connect now provides access to the world's second largest equity market with more than 4,000 listed companies and a combined market capitalisation of 9 trillion US dollars. If we are to take account of all these companies, then they would form more than 40% of the MSCI Global Emerging Market Index – a deficiency not lost on the main index providers who have begun including mainland Chinese equities in their indices. For now though, mainland China represents less than 3% of global portfolios despite being nearer 20% of global market capitalisation.

The low level of foreign participation – understandably influenced by historic access difficulties – does suggest that even sophisticated institutional investors across the world are not necessarily aware of, or only starting to fully appreciate the potential from participating in Chinese growth, which is very domestic in nature. The investors may be unaware that these markets have become much more accessible and instead may be relying on larger headlines such as "trade wars" or "poor governance". RisCura, and our clients, have had the advantage of witnessing and studying the growth of Johannesburg-listed Naspers through its investment in Tencent as well as the diversity and pricing of the Chinese market through research over the last five years.

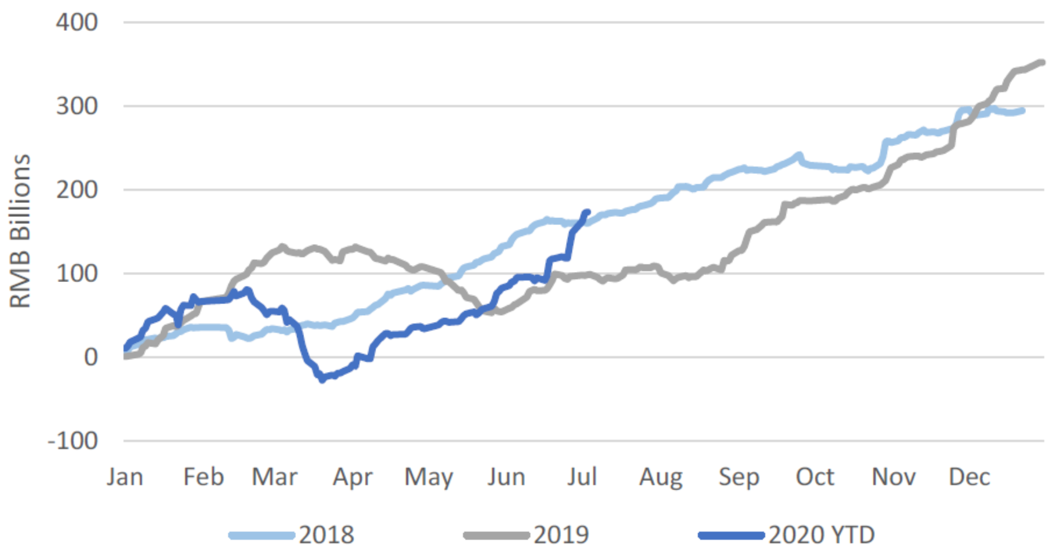
Chart 6: Foreign ownership of A-share companies



Source: Cephei, Wind.

Yet things have started to change. Foreign capital inflows have been accelerating since the launch of Stock Connect.

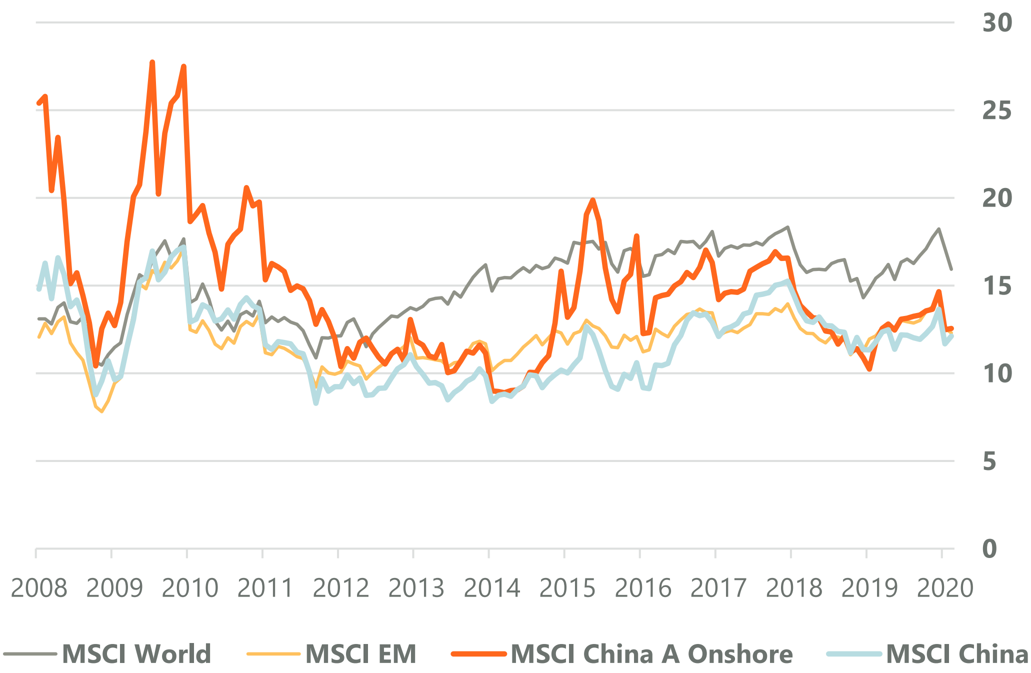
Chart 7: Foreign inflow via Stock Connect



Source: MegaTrust, Wind. As of July 2020.

Chart 8 shows the expected forward price to earnings ratio of Chinese listed companies compared against emerging and global markets. China scores favourably: the forward P/E remained compelling.

Chart 6: Forward pricing of selected equity market indices



Source: MSCI, Bloomberg; Chart shows forward PE ratios for selected MSCI indices; data from Jan 2008 - Feb 2020 Note: Historical data - not an investment recommendation.

It is clear that as global equity indices (and hence investor benchmarks) include Chinese markets more, then more capital will enter the markets - a dynamic that should result in more efficient market pricing. As more capital from 'sophisticated' global investors enters the market, it is reasonable to expect valuation methods and price discovery will transition to being closer to those used in developed markets. In the meantime though, retail investors dominate and will continue to do so for some time. This presents incredible opportunities for sophisticated investors.

5 Investing in the Chinese equity market

Types of China listings

As the Chinese equity market has developed, several types of shares have come into existence (summarised in Table 2). At the highest level, one can distinguish between those stocks that are listed on one of the mainland exchanges, Shanghai and Shenzhen, and those listed in Hong Kong or outside of China.

Table 2: Different share types for China listings

TYPE	DEFINITION	STOCK EXCHANGE	CURRENCY	MARKET CAP (USD bn)	MARKET CAP (USD, %)
A-Share	Shares trading in mainland China with access through QFII and RQFII licences as well as the Shanghai-Shenzhen Connect	Shanghai Shenzhen	RMB	2,000	57.6%
B-Share	Shares trading in mainland China, with unlimited access for global investors	Shanghai Shenzhen	RMB	< 3	0.1%
H-Share	Chinese stocks listed in HK	HK	HKD	480	13.8%
Red-chips	Majority state-owned Chinese companies, incorporated outside of China, but listed in HK	HK	HKD	210	6.0%
P-chips	Non-state owned Chinese companies, incorporated outside of China, but listed in HK	HK	HKD	390	11.2%
N-Shares (Overseas ADR / GDR)	Chinese companies listed on international exchanges, using a depositary receipt structure	NYSE Nasdaq Singapore	USD	390	11.2%

Source: Atlantic, MSCI as at Sept 2017

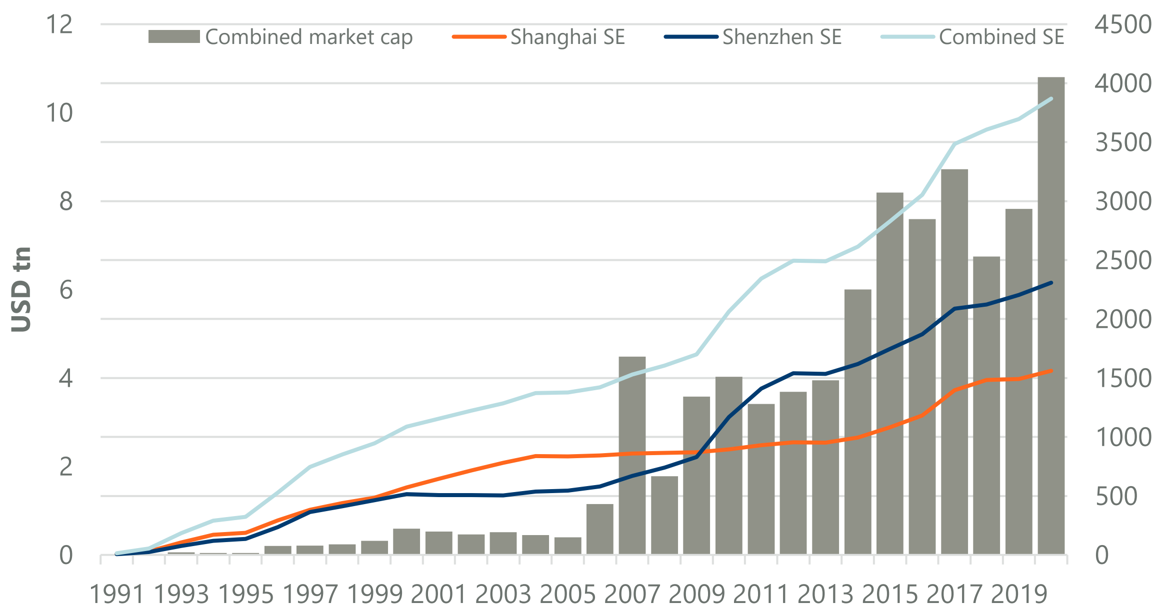
Historically, global investors have focused on the international and Hong Kong listings, but the Chinese A-share market is second in size only to the US (as Chart 12 later shows). This sheer size is an important and compelling argument for inclusion within global indices, and investors' global portfolios. China is a substantial portion of the global equity opportunity set, and it stands to reason that it should constitute a similar proportion of investors' portfolios; ignoring it could become increasingly costly as opportunities are missed.

Market size

The Chinese market is very active and boasts a very high turnover relative to its market size – well in excess of twice the market cap is traded annually. Much of this activity is created by abundant retail investors or mutual funds aimed at retail investors – an aspect we will return to later.

There are two main stock exchanges on the China mainland: Shenzhen and Shanghai.

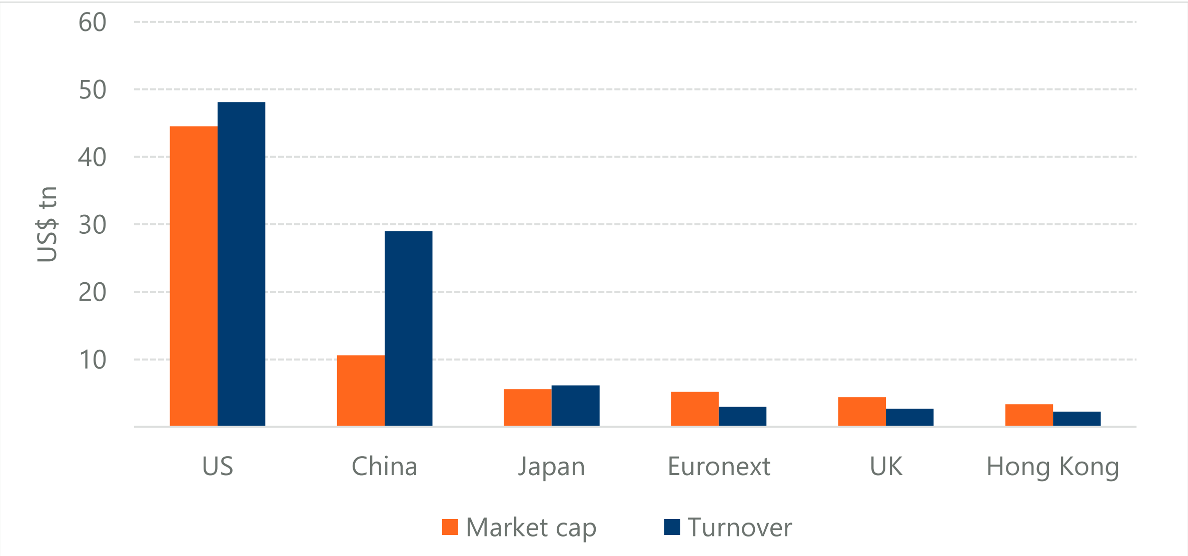
Chart 7: China market capitalisation and number of stocks



Source: RisCura research, Shanghai Stock Exchange; size and turnover as of Nov 2018

Chart 7 demonstrated how relatively new these stock markets are and how rapidly they have grown over time. This growth has been exceptional – one is prompted to ask: can it continue? The answer will be a function of continued economic growth and of the state's ongoing encouragement (or otherwise) of the capital markets.

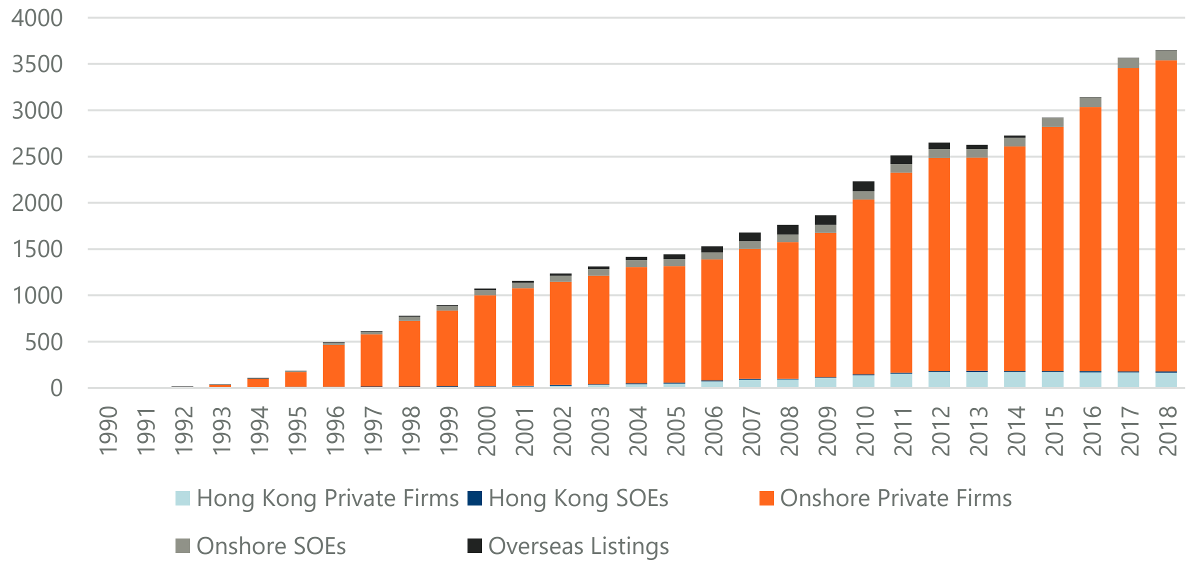
Chart 8: Market size and turnover



Source: RisCura research, Shanghai Stock Exchange; size and turnover as of Nov 2018

As shown in Chart 8, the annualised trading volume in China A-shares is relatively large, and outstrips its market capitalisation. The extent of this excess is larger than in most other markets (in western markets trading volume is usually similar in size to market capitalisation). Chine volume reflects a higher proportion of stocks bought and sold by domestic, retail investors in China.

Chart 9: Growth of private companies in China



Source: Investec

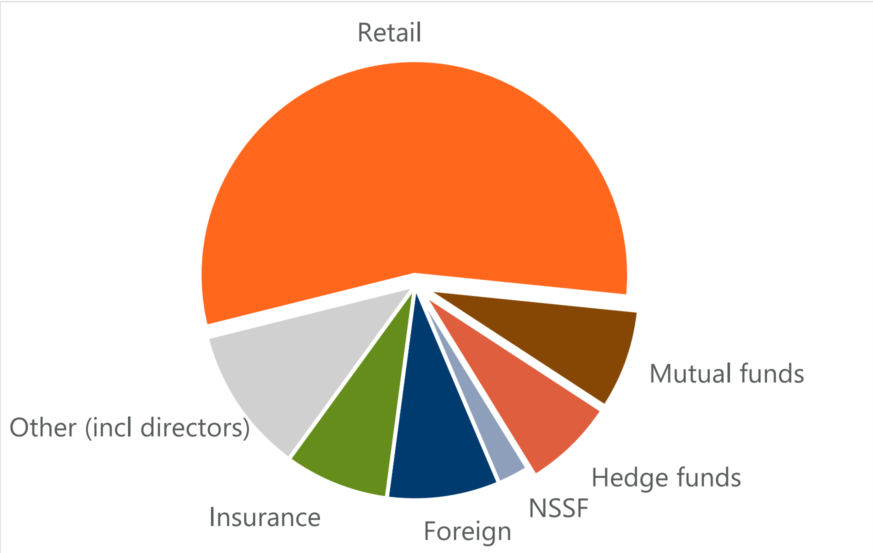
Chart 9 illustrates the growth of private companies over time. The rise of these companies has increased the depth of the stock markets significantly whereas previously they were dominated by State Owned Enterprises partially or mostly owned by the government.

<u>Observation:</u>

This is a new market; companies are new and so is the asset management industry. The opportunity set has evolved rapidly and continues to change.

The dominance of retail investors – and the opportunity this creates

Chart 10 : A-share ownership

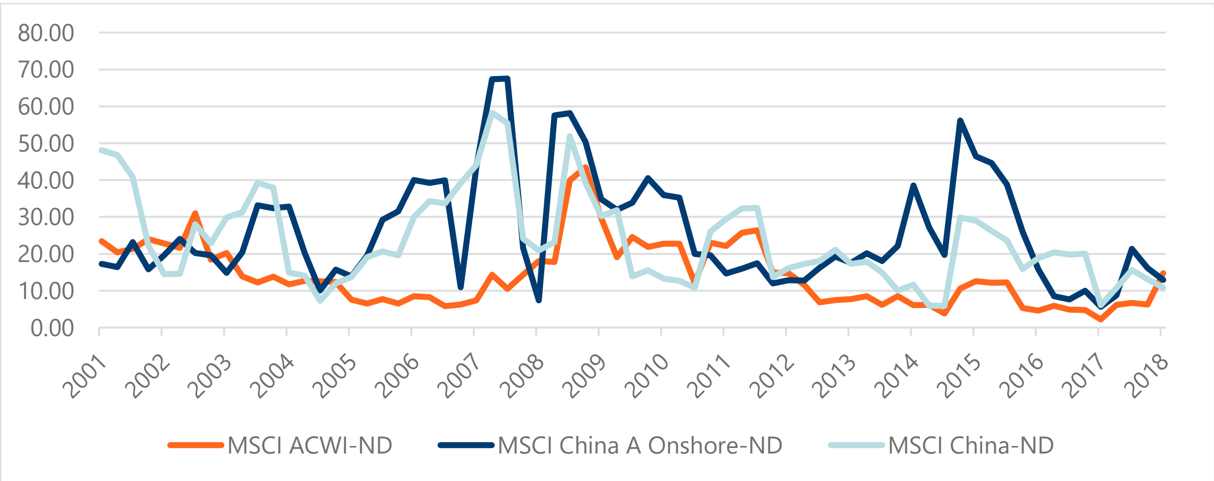


Source: Aberdeen Standard Investments, data from Dec 2018

The significance of retail investors (including many mutual funds who are operated by ex-retail investors and adopt similar trading pattens) cannot be understated. Owning over 50% of the market and responsible for an estimated 80% of trading volume means the associated short-termism combined with specific Chinese cultural traits mean that the stock market has been volatile (Chart 11) and potentially mispriced, due to lack of adequate information processing by traders. Almost two-thirds of mutual fund investors have less than 3 years experience according to data from 2017. Retail investors typically are more emotional, less informed and more prone to following trends and patterns than institutional investors.

While this all may change as the proportion of institutional investors increases both locally and from outside China, we expect volatility and potential mispricing to continue. However, where there are inefficiencies there are opportunities to exploit – **this is demonstrated by the magnitude of alpha that managers have generated historically**.

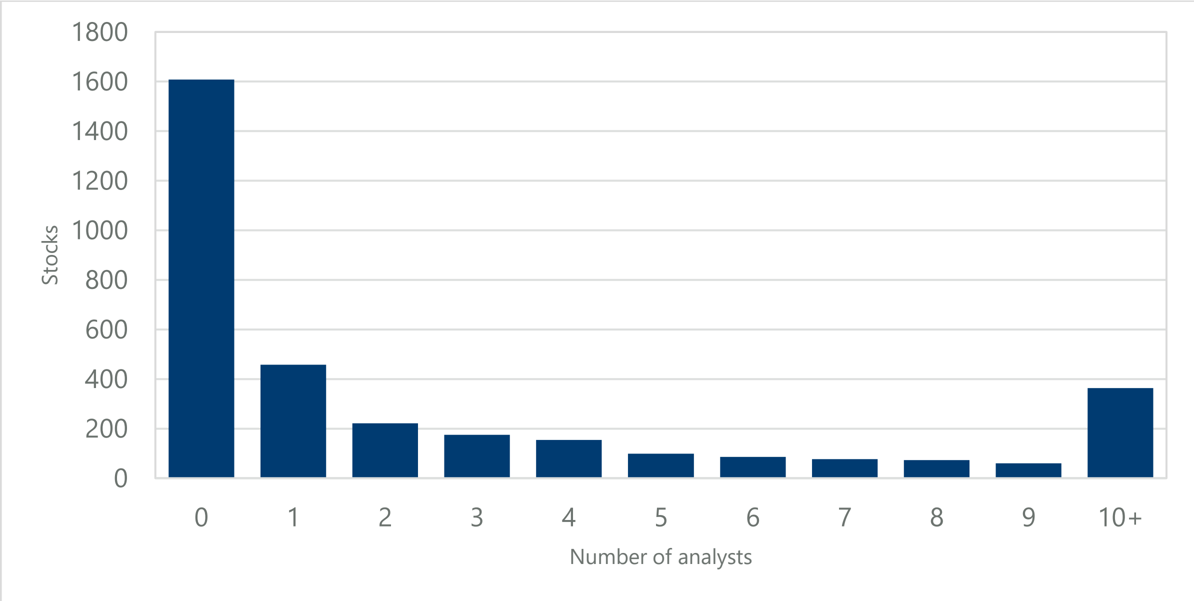
Chart 11: Volatility compared with global equities



Source: eVestment

Another way to examine the efficiency of the market is to look at analyst coverage which would be an indicator of institutional "interest". As seen in Chart 12, more than half of the listed securities in the mainland exchanges have no analyst coverage at all. Some of these will be small companies where coverage is not warranted however among them will be many companies that are sizeable but simply underresearched.

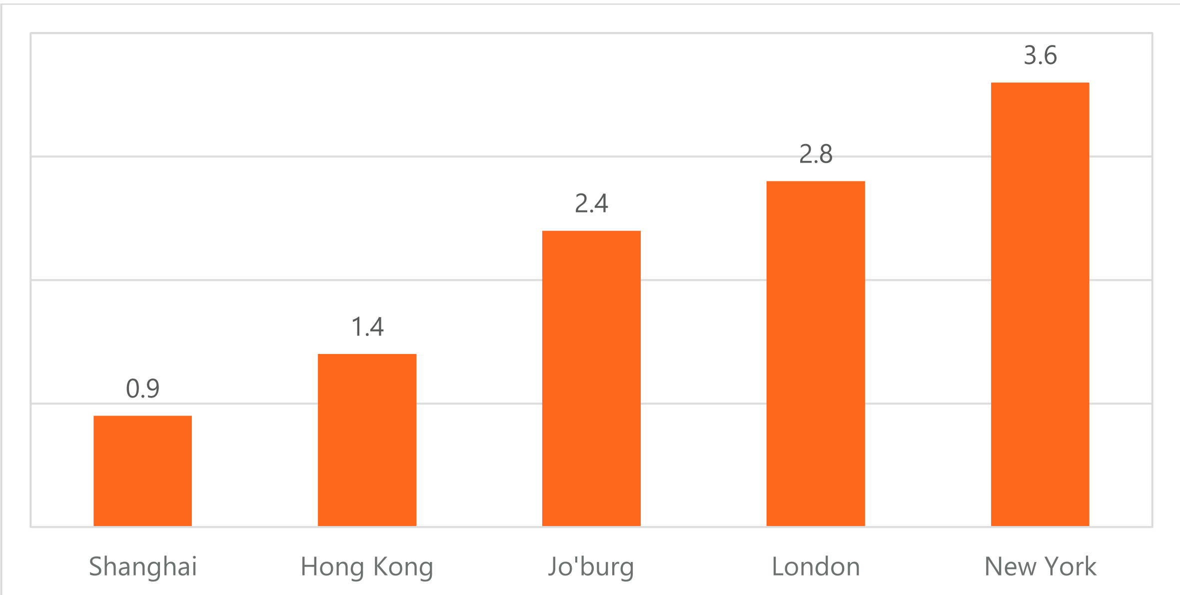
Chart 12: Analysts per listed security



Source: Wind and AB, Bloomberg, Cederberg Capital; data as of Sep 2018

The same thing can be seen when comparing the number of analysts covering the average small-cap company in a number of markets (small cap here being stocks with market values of $100m - $1bn). On the China mainland exchanges the coverage is considerably less suggesting a much greater potential for market mispricings.

Chart 13: Small cap analyst coverage

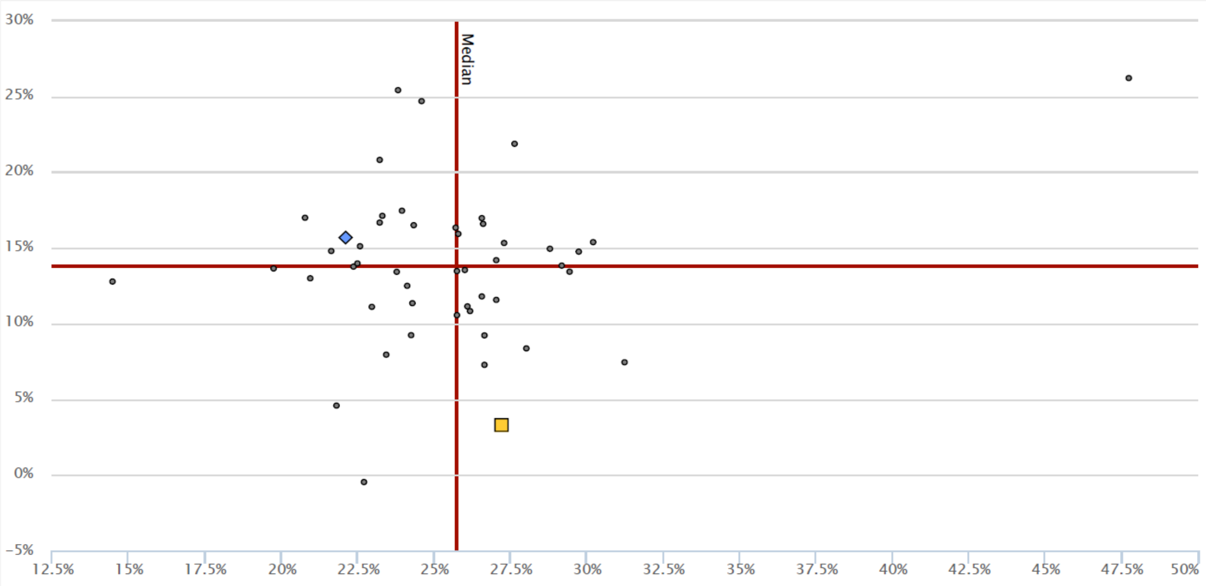


Source: Wind and AB, Bloomberg, Cederberg Capital; data as of Sep 2018

An extraordinary active management opportunity

Against this backdrop, we submit that passive investing is not advisable and more importantly that there is a **substantial opportunity for skilled active managers** - which is borne out by our research. Even a relatively simplistic search of the manager universe reveals subsets of active managers who have delivered median annualised outperformance (or alpha) of near 10% per year over long periods of time, as shown in Chart 16.

Chart 14: Outperformance of Chinese active managers



Source: eVestment

<u>**Observation:**</u>

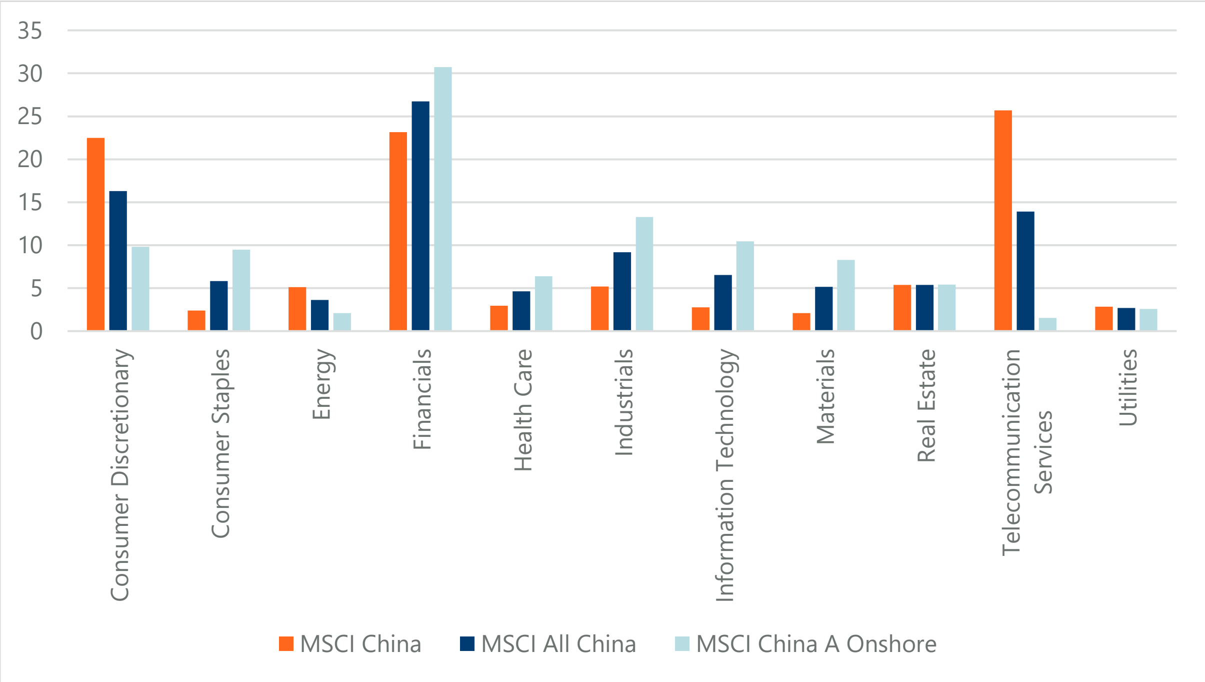
The Chinese market is highly inefficient; this suggests passive investing is inefficient and there are significant outperformance opportunities for active managers.

The observation applies not only to active management but to manager selection in general. With a shortage of 'global best practice' manager selection consultants operating in China, the selection of any one or more managers is inefficient and only a specialist can add the necessary value in portfolio construction.

Benchmark choice affects sector exposure

It is also worth noting that sector exposures vary across the different China equity markets, and thus, depending on the (presently available) benchmarks that an investor chooses, the investor can get markedly different base line portfolio exposures, as illustrated in Chart 15.

Chart 15 : Sector exposure of the China Indices



Source: MSCI

Most of corporate China is listed domestically while the industry diversification of Chinese companies that are listed outside of China is poor and significantly skewed towards Telecommunication Services and Consumer Discretionary at the expense of Industrials, Consumer Staples, Healthcare and Information Technology.

The offshore Chinese index (MSCI China), suffers from concentration issues in that Tencent and Alibaba form over 30% of the index and much of the performance of the indices has been driven by these two companies.

On the other hand, the onshore index (MSCI China A Onshore) is much more diversified and comparable to Nikkei 225 and S&P 500.

Table 3: Concentration of China indices

Index	Top 5	Top 6-10	Top 11-20	Top 21-40	Balance
MSCI China (Offshore)	39.6%	9.5%	9.0%	10.2%	31.7%
MSCI China A (Onshore)	17.3%	7.2%	11.3%	15.1%	49.1%

Source: MSCI as at June 2019

The onshore China A-shares index is much more diversified and therefore the performance drivers are wider. More importantly, Chinese A-shares are exposed differently to offshore counters, and so provide good diversification for any other emerging market programme, which may largely have Hong Kong and US depository receipted Chinese counters. The following table demonstrates the lower correlation between China A Shares and other global indices. It also demonstrates the high correlation between offshore China and emerging markets.

Equity Indices	China A	China Offshore	Emerging Markets	World
China A	1.0	-	-	-
China Offshore	0.6	1.0	-	-
Emerging Markets	0.5	0.9	1.0	-
World	0.4	0.7	0.8	1.0

Source: MSCI, eVestment, 10 years ended Dec 2018

Foreign access

QFII and RQFII

Shares listed on the Shanghai and Shenzhen stock exchanges and denominated in Renminbi[2] (primarily A-shares) have long been difficult to access for non-Chinese investors. In 2002, the Qualified Foreign Institutional Investor (QFII) programme was launched to allow a select number of non-Chinese investors to invest in mainland shares, while abiding by a strict quota limit. The quota limit had been incrementally increased over time and was scraped very recently, but large institutional investment remained limited. Foreign investors tended to access Chinese stocks through shares listed in Hong Kong or through depository receipt structures, often listed in the US as American Depository Receipts (ADRs). The China Securities Regulatory Commission (CSRC) set the criteria for obtaining a QFII licence, which included a number of stringent requirements such as business experience, operational set-up and minimum thresholds of assets under management.

The introduction of the Renminbi QFII (RQFII) programme introduced a similar, but modified version of the programme to foreign investors, to ease the constraints of the initial programme. The main difference is the use of Renminbi to purchase securities through this version, rather that the investors' domestic currency, but there are a number of other differences between the two programmes. RQFII licences are only granted to institutions in certain countries or regions, for example Hong Kong, UK, Singapore, France, Korea and Germany.

Those investors who did not have a QFII or RQFII quota could gain exposure to onshore companies through notes issued by investment banks. However, this came with counterparty risk and the trading costs were quite high.

Stock Connect

In November 2014, the Stock Connect initiative was launched, starting with a link between the Hong Kong and Shanghai exchanges. It was followed in 2016, by a direct link between Hong Kong and Shenzhen. It allowed foreign investors to simply access shares on the mainland through the Hong Kong exchange, which non-Chinese

[2] "Renminbi" is the official name of the currency introduced by the Communist People's Republic of China at the time of its foundation in 1949. It means "the people's currency". "Yuan" is the name of a unit of the renminbi currency.

investors have free access to. It also provides some access to Hong Kong listed companies for onshore Chinese investors.

This investment channel has largely marginalised the (R)QFII programme, as it provided a simpler method to invest in mainland shares as well as a larger opportunity set, although a daily quota still remains in place and Stock Connect does not provide access to the entire onshore universe. Northbound daily quota – measuring inbound capital from Hong Kong to the mainland – is limited to RMB 52 billion for each of Shanghai Connect and Shenzhen Connect. It allows (at this stage) both retail and institutional investors outside of mainland China to access A-shares (but not B-Shares, ETFs, bonds, etc), in a relatively straightforward manner. Given the lower costs of accessing onshore companies through Stock Connect, the initiative has also resulted in higher costs for those who still prefer to access exposure through investment banks.

As of today, there are over 3,500 stocks listed on the Shenzhen and Shanghai indices in aggregate. The Stock Connect programme gives access to majority of these names, although it does exclude several (referenced below) that the stock exchanges and the regulator deem inappropriate for the scheme.

Furthermore, the number of listed stocks is growing at great speed: in the last couple of years there have been hundreds of IPOs in the China A-share market each year, paired with an increasing number of privately held companies being set-up across the board.

In summary, the Stock Connect has, for the first time, provided easy access to onshore Chinese companies. This paves the way for global emerging market and greater China funds to increase their investible universe significantly. There are some limitations to this process (although these restrictions are being adjusted to become more flexible over time) that include daily trading limits, although aggregate quotas have been abolished. The Shenzhen Connect is limited to institutional investors, but will likely open to all over time (as is the case with the Shanghai Connect). And finally, there are still several stocks that are not tradable through the systems and these include some small-caps (due to liquidity), stocks on "risk alert" and those stocks that are in the process of being delisted. These exceptions are by far in the minority.

Table 4: Foreign access and index milestones

2000	▸ No foreign access at market launch
2002 - 2012	▸ QFII and RQFII schemes launched in 2002 and 2011 - **allow access but cumbersome; restrictive quotas**
2013	▸ QFII repatriation rules relaxed ▸ First RQFII awarded and RQFII expanded to Singapore / London
2014	▸ Capital gains tax clarified ▸ RQFII expanded to more cities ▸ **Shanghai Connect launched - allow purchase of A shares through Hong Kong**
2015	▸ RQFII expanded to more cities
2016	▸ QFII/RQFII quotas linked to fund size, beneficial ownership clarified ▸ **Shenzhen Connect launched**
2017	▸ Exchange pre-approval requirements loosened (had restricted creation of index-linked vehicles)
2018	▸ SSE introduced MOC ▸ Suspension rules tightened ▸ **Connect daily quota quadrupled**
2019	▸ Global indices increase onshore China inclusion ▸ QFII quota doubled ▸ **London Connect launched**

Source: MSCI, Shanghai Stock Exchange

Equity index inclusion

The main index providers have historically chosen not to include China A-shares into their mainstream indices. Global and emerging market indices have had a China allocation, but purely through shares listed in Hong Kong or through depository receipt structures (primarily) in the US. This has not only tilted indices to specific jurisdictions and sectors, it has also resulted in a structural underweight of Chinese shares in comparison to the nation's contribution to global economic output. This is set to change, albeit slowly, as MSCI (a premier index provider) finalised its consultation on A-share inclusion during 2017, and the subsequent decision to start including a limited amount of A-share stocks in their flagship indices in 2018. This has followed the successful introduction of the Stock Connect programme. FTSE/Russell, another index provider, has followed a similar approach.

MSCI specifications

The initial phase of inclusion was capped by a 5% inclusion factor and limited to 235 large cap stocks. This means that in the first instance, the calculation of relative weight in the index has been capped by a notional 5% of market capitalisation. In effect, MSCI is artificially treating these 235 stocks as if they were a mere 5% of their size today, resulting in a much smaller allocation to the index at this stage.

The stocks were included in two equal tranches in May and August 2018, to smooth the inclusion process. Since then MSCI has progressively increased the inclusion factor from 5% to 20%, in three steps, during 2019 (respectively in May, August and November). There are now 253 Large and 168 Mid Cap China A shares, including 27 ChiNext shares, representing a weight of close to 4% in the index. MSCI will also consider any further actions taken by the Chinese authorities to allow easier access to the local market, and by evaluating its initial inclusion stage for any problems or inefficiencies, in deciding the pace and scale of further inclusion. Limits on foreign ownership of Chinese companies will also be a factor (currently this is around 30% for most companies).

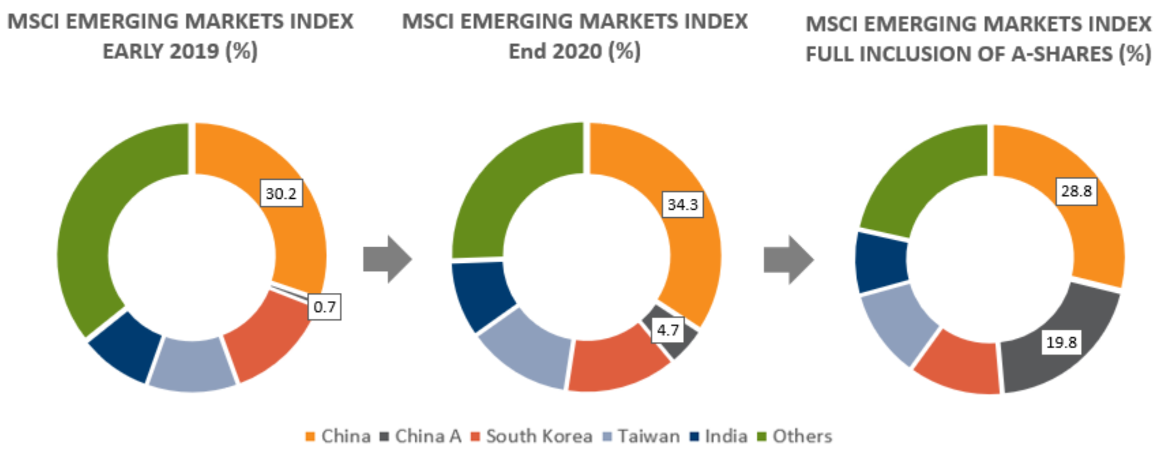
In terms of timelines for inclusion, comparisons may be drawn from Korea or Taiwan, where full inclusion into the MSCI indices took six and nine years, respectively. The A-share inclusion started with a lower inclusion factor than applied to both Korea and Taiwan (which were 20% and 50%, respectively). However, many expect full inclusion to happen at a more rapid pace for China A-shares as the market becomes increasingly important and the Chinese authorities focus on accommodating MSCI and other index providers' requirements as part of their more outward-looking overall perspective. MSCI has historically been cautious in its inclusion due to the amount of money that tracks its indices and, with China and its particular idiosyncrasies around capital controls and trading restrictions, A-share inclusion needs to be progressed with particular care.

Dealing with equity trading suspensions is also very important. Trading in more than half of the companies in the A-share market was suspended as a result of share price volatility in 2015. As soon as suspension of an A-share stock reaches 50 consecutive business days, MSCI will delete the name from their indices. Temporary trade suspensions are not uncommon in markets around the world, where excessive volatility is curbed with restrictions on trading for large price movements (the term "circuit breakers" or "limit down closure" might be used elsewhere). Having said that, the Chinese regulators have been noticeably reducing their use of suspensions over the past years.

MSCI also plans to exclude *newly* eligible securities (i.e. those that are not current index constituents), if they have been suspended for 50 consecutive business days in the past 12 months, or are suspended on the price cut-off date of inclusion.

Chart 16 demonstrates the consequences of MSCI moving to full inclusion over the coming years. While there is no definitive timeline for full inclusion, our understanding is that MSCI is on course to do this and inclusion is inevitable. Full inclusion will lead to China being more than 40% of the MSCI Emerging Markets index. Meanwhile, MSCI has released a family of indices that take account of Chinese companies in different ways, including full inclusion.

Chart 16 : MSCI inclusion



Source: MSCI

RisCura believes that the index inclusion which was completed in 2019, whilst for now modest in size, will bring more attention towards the Chinese equity market and may lead to significant flows as the world realises the size of this market.

Index inclusion matters a great deal to benchmark-tracking investors. If the 'target' weight for China A shares increases then any investor who intends to track the weights of global indices would need to adjust their holding – in this case, by purchasing additional exposure to A shares – to get their portfolios to reflect the new, higher weighting. While not of itself a reason prices will rise (the inclusion having being well-publicised), this 'tailwind' of purchases can provide a supportive environment for prices for an extended period.

Another aspect is that index inclusion increases visibility of the constituent companies, which all else equal should likely result in more accurate valuations, and hence tougher alpha generation as time goes by.

Observation:

Investing in China to capture the extraordinary alpha opportunity is time sensitive. Prices and the mechanism for price discovery will be impacted as flows from foreign investors increase.

6 Asset management in China

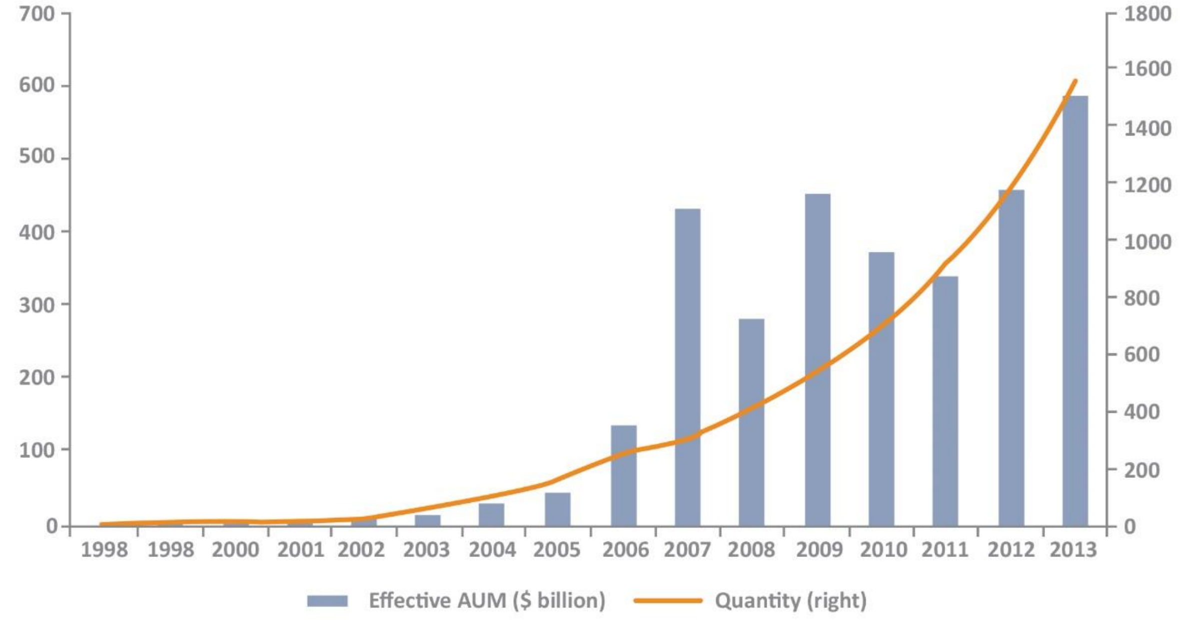
History of the asset management industry

The asset management industry that specialises in China can be split into two 'heritages':

1. **Global asset managers** that have invested in Asia including (offshore) China for many years
2. **Chinese specialist asset managers** based on the mainland

The asset management industry is fairly new in China. The first official licences to allow banks to create 'mutual funds' were awarded in 1998 to a select number of State-Owned Enterprises. Private asset managers were not allowed until 2004 and the industry only started to grow at this point.

Chart 17: Development of mutual funds in China



Source: The Asset Management Industry in China, Zhiwu Chen

In general, an insufficient part of the industry was of institutional quality until recently. It continues to be dominated by the highly speculative retail investor base but as time has progressed the asset managers have institutionalised, with some managers now reporting 10-year track records and a 'best-in-class' breed has started to emerge. However, this is a recent phenomenon.

In contrast, professional institutional asset managers have invested in Asia from a Hong Kong base for many decades, and many have been investing in Chinese companies listed in offshore markets. The challenge is that these asset managers are very new to investing in *mainland* Chinese companies. Even the most experienced have only done this since 2005, when the QFII quota mechanism was refined sufficiently to practically allow offshore asset managers to invest in China. The sheer volume of mainland Chinese companies remains a challenge: a 4000 stock universe with language barriers and different accounting standards hamper in-house research, and external broker research coverage remains limited. Also, limits on foreign ownership of mainland asset management firms has historically acted as a disincentive for global firms to establish mainland subsidiaries – instead of effectively surrendering the majority benefits of their knowledge, skills and processes, the global firms have opted to remain out of the mainland industry.

Suffice to say that the domestic industry is nascent, which means (amongst other things), that the Chinese have only recently built up the required level of investment professional talent. In addition, offshore managers (including Asian specialists) have only recently started to cover the sheer breadth of the mainland Chinese investment universe. Chinese investment professionals returning home from investment houses across world, including London and the USA, have helped to improve the situation.

The newness of the industry and its unsettled state is comparable to the **challenges in manager selection** that are associated with new asset managers:

- Short performance track records
- Many products tailored to a retail client base
- High staff turnover
- Changing processes to improve and to adapt to a fast-changing investment environment
- Greater operational risks
- Relevant experience being low for the entire industry

Different approaches and portfolio characteristics

Comparing global managers with Chinese specialists we could draw up the following table:

GLOBAL MANAGERS	CHINESE SPECIALISTS
Established process	**Evolving processes but more relevant**
Longer investment holding period	**More tactical position-taking**
Deep sector expertise	**Deep stock expertise**
Diversified across sectors	**Often sector focused**
Often have large-cap focus	**See opportunities in small & mid cap**
Often rely on quant screens, broker coverage or thematic research	**Deep understanding of macro and regulatory impact on sector**
Diversified portfolio	**Concentrated portfolio**
Benefit from macro view and worldwide experience in research	**Regional and cultural experts focused on local market**

Each has its advantages and drawbacks. A well-constructed China allocation would seek to draw on both sides.

Observation:

Given the industry is relatively new it is not yet clear where winners and losers will emerge, and diversification of managers is critical.

Additional considerations when selecting China managers

The newness of the asset management industry poses some additional complications which a prospective investor should be aware of and incorporate into their portfolio decision.

As indicated earlier, **operational risk** is likely to be higher for the average China-based manager compared with managers based in more familiar developed markets. Unless the work is delegated to a consultant or fund of funds the investor should expect to budget a larger amount of time and resources monitoring their China managers. These managers may be less familiar with best practices or simply less willing to engage with their customers on matters of **governance, compliance**, **transparency**, **auditing** and so on. Having direct exposure with these managers is therefore operationally the riskiest proposition for investors, and will warrant significant additional, specific and detailed initial and ongoing research to fulfil and satisfy oversight and governance checks. This includes the initial contracting, which for each manager will be unique. In addition, there may be increased compliance and administrative requirements placed on the investor once the investments have been made. The increased governance required from an investor for a relatively modest allocation of total assets (perhaps 3%), distributed among 6-8 managers, needs to be considered carefully.

Track records will be short. The very longest will be around 15 years, with the majority having less than 10 or even less than 5 years. This complicates performance assessments and evaluations.

Cultural differences and **language barriers** will make effective evaluation and monitoring more complex. For example, Chinese managers may **avoid awkward questions** or be less forthcoming with negative information – a hazard in any society with a collective culture, where the opinion of the group is everything. People may prefer not to lose face by keeping a pleasant disposition and avoiding negative information. If they do make a mistake, they may never acknowledge it.

Talent will be mobile. Like with any relatively new industry, participants will evolve and change and teams will form and reform until the industry settles down. This impacts both the selection of a manager as well as the decision to retain that manager over time. Changing the allocations through time will require flexibility and speedy decision making giving the dynamics of the market.

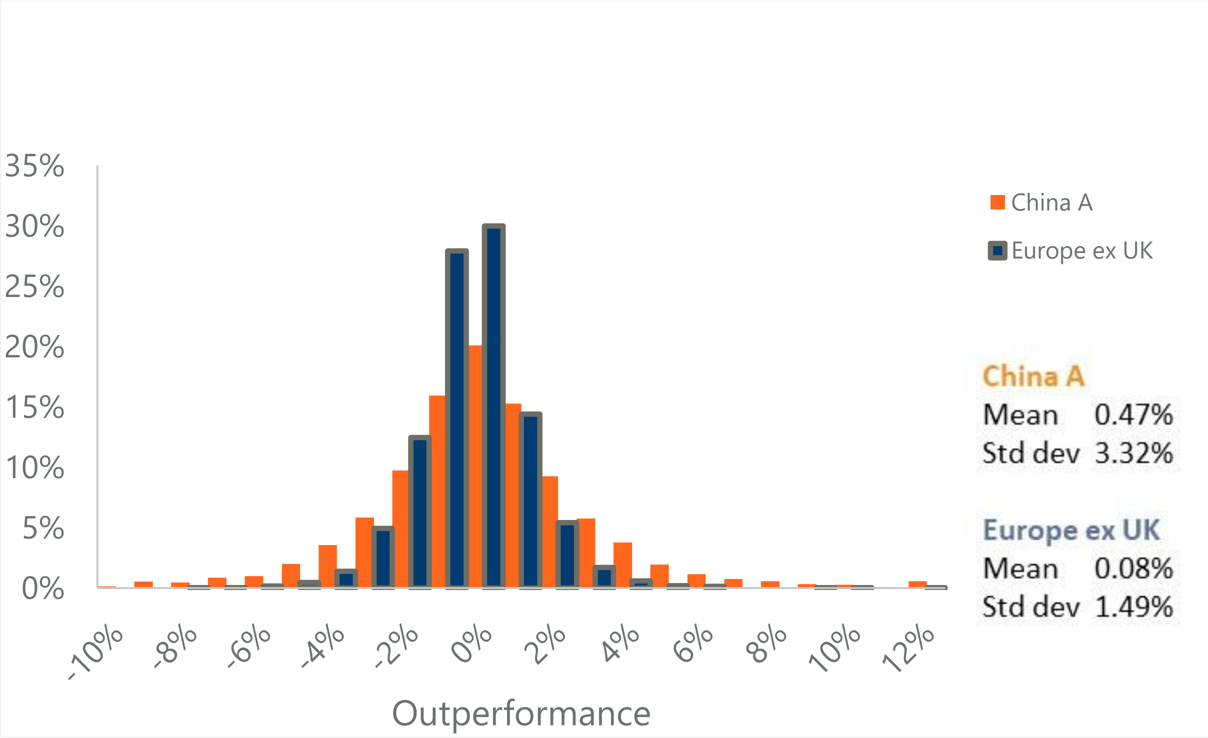
Managers may be **unregulated**. An investor may be limited to working with those managers who are appropriately licensed or approved in the investor's home country to manage assets, and from those only products which are approved for sale in the investor's home country. Some of the managers may not have an appropriate pooled fund available and the small allocation from even a very large investor may not be sufficient to justify a segregated mandate and/or improved fees. Many China managers have set up funds in various jurisdictions, to cater for global investors. It should however be emphasised that the likelihood and opportunity to attain exposure in smaller quantities to pre-selected managers identified by RisCura or another advisor could become increasingly difficult, as there is a strong possibility of larger (global) investors taking up capacity with these managers. Nevertheless, where clients wish to have a broad mandate, some China managers may be willing to gain the required licenses – although this process can take several months. RisCura can work with the managers to try to achieve this.

7 Multi-manager or single manager?

A common question we face is how many managers to allocate to – whether in China or elsewhere in the portfolio. A single manager may deliver exceptional returns but at great risk (volatility or risk of severe underperformance). A combination should be less volatile but may deliver disappointing results.

We conducted a simple exercise comparing the China mainland manager results against a (somewhat arbitrarily but perhaps meaningful) alternate region, in this case the Europe ex-UK manager universe. Taking data over a recent 5 year period we noted that the distribution of realised monthly outperformance for the China cohort was considerably wider than the Europe cohort.

Chart 18: Distribution of monthly outperformance
China vs Europe ex-UK

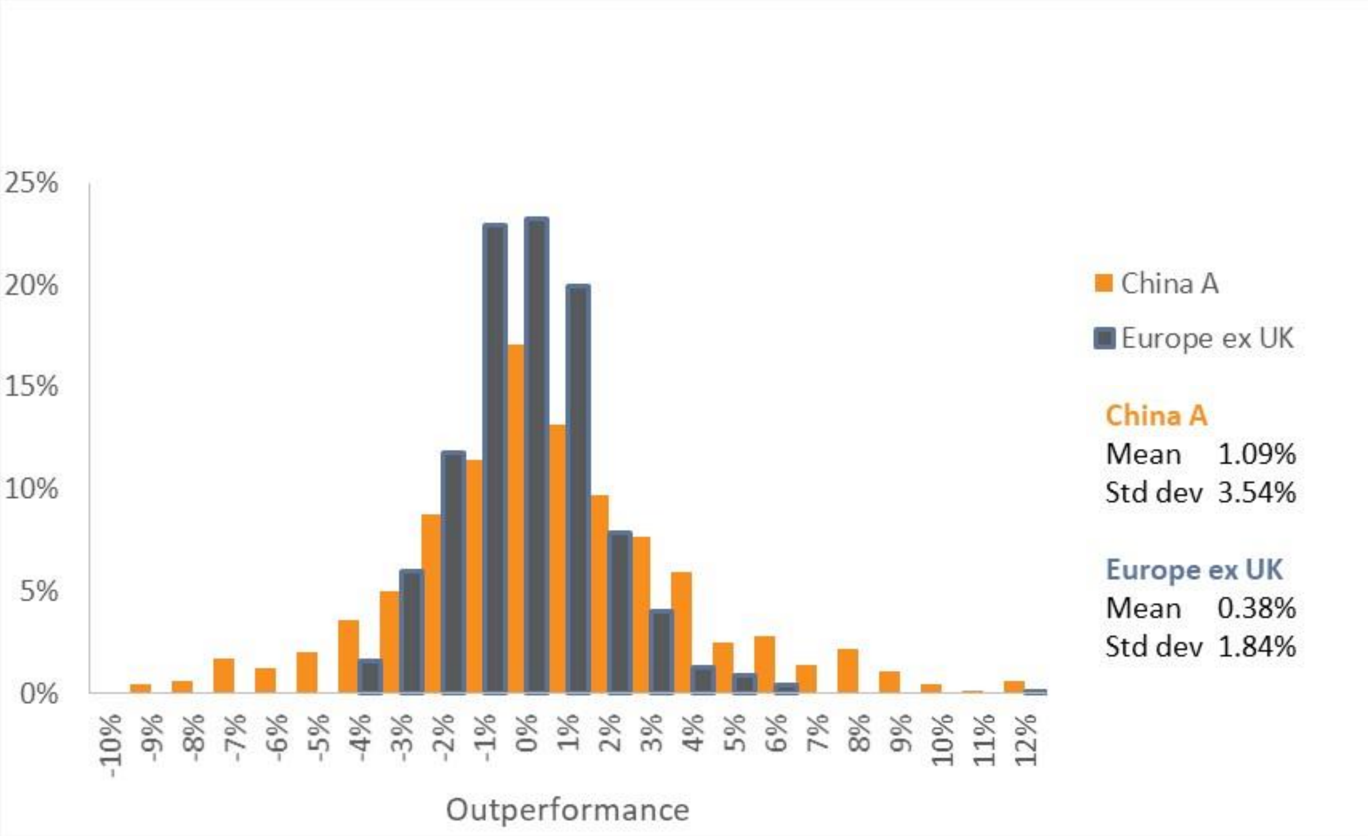


This result in itself was not a surprise: given the inherent volatility of the Chinese market, combined with the tendency of managers to run much more concentrated portfolios, we could have suggested *a priori* that outperformance would be more volatile. However, what this immediately implies is that the risk reduction benefits from combining multiple managers is much greater in (mainland) China than it would be a developed region in Europe ex-UK, where results have a much narrower distribution. In other words, the risk reduction benefit of each additional manager in China is much greater than in Europe ex-UK (providing of course they are uncorrelated/following a different strategy)

We then considered the likely counter-argument that a skilled manager selector would not have exposure to the entire universe but instead would be able to identify the best performing candidates and allocate only to these.

We redid the exercise considering only the top 10 managers – with hindsight – in each universe. In other words, assuming the manager selection specialist had perfect foresight to identify the most successful managers, what would the experience be? The results were surprising:

Chart 19: Distribution of monthly outperformance
China vs Europe ex-UK - top 10 managers



This result was surprising. **The top 10 managers in China had a similar likelihood of poor returns as their peer group.** In Europe ex-UK the distribution for top managers was narrower. This suggested that Europe ex-UK managers were more likely to have small but consistent outperformance compared to their peers. In China, even the top 10 managers – with perfect foresight – were likely to deliver a very volatile intra-period result. We consider that many allocators would find this unattractive. On a risk-adjusted basis a **substantially superior outcome** could be obtained by **allocating to several of the top 10 managers**; indeed allocating to all 10 would be a viable strategy.

8 RisCura's approach to obtaining China exposure

Specialist managers required, and diversification is essential

Throughout this report we have made several important observations that need to be considered when implementing:

1. A **diversified** portfolio across sectors will capture a wider breadth of growth drivers.
2. A **multi-manager** allocation will deliver better risk-adjusted returns than trying to select the top performing single manager.
3. This is a new market; companies are new and so is the asset management industry. The opportunity set has **evolved rapidly** and continues to change.
4. The Chinese market is **highly inefficient** – this suggests passive investing is redundant and creates outperformance opportunities for active managers.
5. Investing in China is **time sensitive**. Prices will be impacted as flows from other foreign investors increase.
6. Given the industry is relatively new it is not yet clear where winners and losers will emerge, and **diversification of managers** is critical.

There are many reasons why foreign managers (i.e. managers based outside of mainland China) may not be suitable to provide the full spectrum of Chinese access:

- The China equity universe is very large – probably too large to cover immediately
- Language barriers when doing own research
- Lack of broker coverage in English for analysts relying on 3rd party input
- Still a highly inefficient market dominated by retail investors, their behaviour and requirements
- Mainland "on the ground" expertise critical
- Offshore managers more likely to focus on well-known globally familiar Chinese companies (such as Alibaba or Ping An) at the expense of more nuanced local competitors

Taking these salient points into consideration, we believe the following are key when investing in China:

1. Invest with **active** managers – this market is highly inefficient. Our own allocations have delivered considerable alpha, at levels not reliably obtainable in developed markets.
2. Stocks are being progressively included in the benchmarks over the next few years. Implementation is required **sooner rather than later.**
3. **Local presence** is essential – include allocations to managers who can find the untapped investment opportunities and avoid the traps.
4. Manager **diversification** is essential – individual portfolios are too concentrated (some managers have as few as 10 stocks in their portfolios), local managers come with operational risk, international managers are new to China and fast-growing companies are plentiful but need deep research. **Concentrated portfolios** can deliver **outperformance** but will be more **volatile**.
5. **Capacity may be limited** – and Chinese specialists can be very selective with their clients – so having access is not always straightforward
6. Total portfolio should include combination of managers covering different specialities by sector and region. A **multi-manager solution** is, again, natural.

Recommended approach to China

China is one country and therefore RisCura believes that the portfolio should allow for the entire on- and offshore universe:

- This includes: A-shares (60%), H-shares and US listed N-shares (40%).
- We expect this distinction to disappear over time following the introduction of Stock Connect and likely further opening of domestic stockmarkets to foreign investors.

Broad diversification will capture more of the growth drivers and reduce operational risks

- A portfolio should include a combination of managers covering different specialities by sector and region (mainland and offshore).
- A **multi-manager approach** should be taken. The portfolio should be diversified across at least six to eight managers:
    - Rapidly-evolving landscape
    - Managers evolving with market
    - Top managers as likely to underperform as outperform
    - Many managers are young (entire industry is young)
- Diversification among managers should be across several dimensions, such as:
    - Styles
    - Types of businesses
    - Experience of investment team
    - Size of investment team

Capturing the active opportunity needs local expertise

- Presence on mainland is essential:
    - Experienced investors in Hong Kong are less experienced with A-shares

RisCura's advantage

As mentioned previously, our senior team has carried out extensive research specifically analysing, evaluating and understanding China – in person and on site over the last several years. This has included multiple trips to Shanghai, Beijing and Hong Kong, with more than 100 meetings in the last six months alone. We also have experienced manager research capability based in the region.

This knowledge is fused with our heritage and experience as an emerging markers manager selection specialist to provide clients with our unique analysis and recommendations. Many of the issues faced by a Chinese manager – like recent formation, short track record or a fluid environment and talent pool – are common in RisCura's home market of South Africa. As such, the experience gained advising on South African managers can be transported directly to a Chinese context.

We are able to offer both advisory services to those clients who prefer to invest directly with a selection of Chinese managers, and also assist with obtaining pooled exposure in a robust fund-of-funds structure where clients prefer to join with others and instruct a professional allocator to oversee portfolio construction and monitoring. We would be happy to discuss the specific advantages and disadvantages of the alternative routes for obtaining exposure to China in a client portfolio.

9 Risks inherent in the Chinese economy

__The State – A double-edged sword__

China as a country – both socially and economically – is strongly influenced (one might say ‘controlled’) by the Chinese state. State interference for the greater good can be a double-edged sword.

It can provide stability and growth but there will be a negative impact when mistakes are made; and mistakes will almost certainly be made! For example, major stimulus was required in 2016 to rectify policy errors in the previous years. Similarly, the tightening of leverage in 2017 was perhaps overdone creating an unplanned slowdown of the economy in 2018.

The Chinese government intervenes in all aspects of the economy; rarely directly but typically through policy changes. This is not new ... the practice has been going on for a considerable time (and happens in most countries to a greater or lesser extent). In China the results can be more material in a short space of time so must be understood to find investment opportunities and avoid traps.

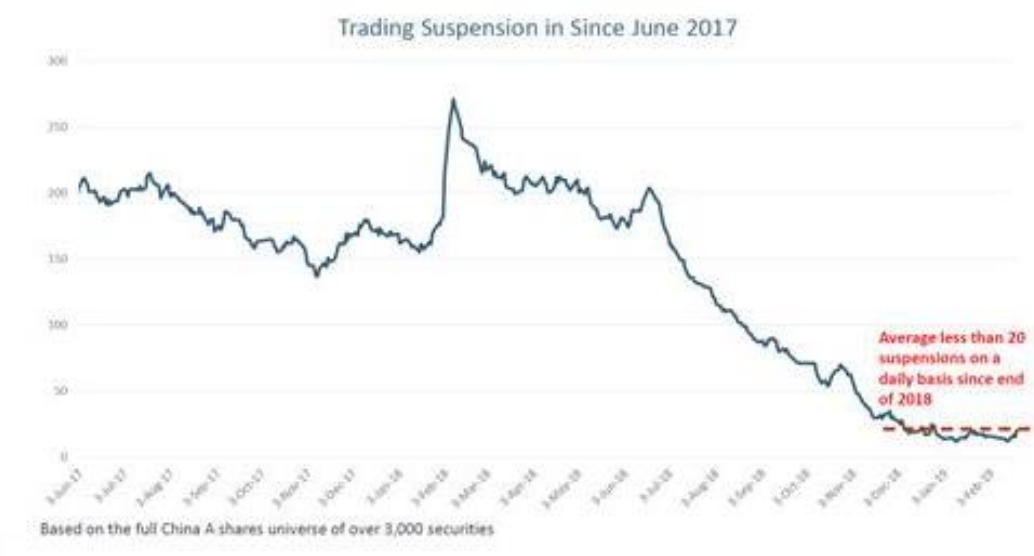
The benefits of well-executed intervention are countless. The centrally controlled Chinese model can achieve goals that other parts of the world can take decades to achieve. Historically this has resulted in the construction of entirely new cities and infrastructure that most developed nations could only dream of. A recent example is becoming the world’s largest producer of renewable electricity in a very short period of time. As a result, the environment theme has been a major opportunity for investors over recent years.

However, understanding government policy is also critical to avoid traps. For example, both the healthcare and gaming industries were severely impacted when the government put policies in place to curb price increases of drugs and excessive time spent by children on games.

__The stock market__

Trading in mainland Chinese equities is also not without risks. Unexplained trading suspensions, for example, are an issue that investors in developed markets rarely need to confront. Such suspensions have reduced (as seen in Chart 21) but they are not yet at a negligible level. However, the attention of global indices has encouraged the Chinese authorities to focus on stock market regulation and improve transparency. On a related theme, insider trading has reduced substantially and many who committed the offence have bene convicted and jailed.

Chart 20: Market disruption

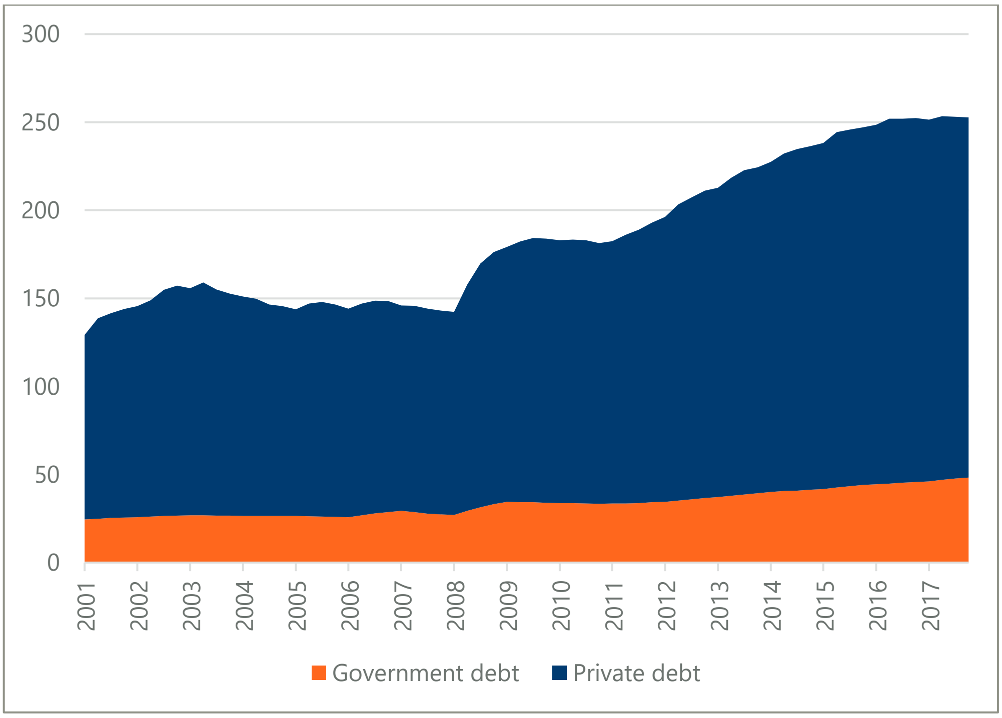


Source: MSCI

Chinese debt

Much has been written about the level of debt in the Chinese economy. Excessive debt can be harmful to any economy, so careful attention to the level is appropriate. China did not "participate" in the global financial crisis of 2008/09 in the same way that developed countries did. Its financial system neither originated nor invested large sums in mortgage-related securities and there was no debt-fuelled housing bubble in the same way as in the United States or parts of Europe. However, it is correct to observe that the overall indebtedness in China since the early 2010s has increased considerably – even if it is now appearing to tail off as seen in the next chart.

Chart 21: National debt as a % of GDP



The Chinese government made deleveraging a central goal and has stabilised the debt to GDP ratio over the last few years as the chart demonstrates. However, economic growth also was severely impacted as a result of this action. Whilst further tightening may be on hold for now, we expect the state to monitor it closely. Furthermore, some major changes have taken place within the financial sector, such as:

- A clampdown on leverage available for equity speculation
- A cleansing of the shadow banking system (shadow banks perform similar roles to regular banks – i.e. collecting capital and allocating it to projects or businesses – but are generally not regulated; an example of a shadow bank could be a special purpose funding vehicle)

Local governments have reduced their shadow banking schemes by replacing them with more transparent bond issuance that are typically guaranteed by the central government.

However, affordable debt finance for the private sector remains an issue. Cheap debt finance from large banks has generally only been available to State Owned Enterprises (SOEs), with private enterprises' cost of borrowing being significantly higher – which meant they historically preferred the rates and terms available through shadow banks. The clampdown on shadow leverage therefore disproportionately impacted private enterprises. This is something the authorities will need to address in the medium term.

In the meantime, the government plans to provide other support to private sector, such as tax reform or subsidies for strategically important initiatives.

10 Conclusion

China has for a long time been an outsized player on the global stage, and over the last 20 years its economic role has increased meaningfully. It has only been over the past couple of years, however, that its stock market has also become of interest to foreign investors. As the world's most populous country opens up to foreign equity, and as inclusion in major indices progresses, it has become critical to take note of the risks and opportunities.

One must bear in mind that there are potentially large benefits by being an early mover into the Chinese markets. This provides a significant advantage in a market that will become far more efficient and well researched over the next five years.

Through Stock Connect, foreign access has become significantly easier. By 2018 MSCI became satisfied that a small inclusion of A-shares in its indices was appropriate, with further inclusions proposed – potentially accelerating over the coming years. With an annual IPO rate of around 500 companies, the mainland China market is only going to make more and more of an impact.

The China mainland market offers **unprecedented opportunities** for skilled (professional) active managers due to the abundance of unskilled (retail) investors.

As non-Chinese investors it is therefore imperative to anticipate this shift, and to start preparing international portfolios for this change.

China's equity market is simply too big to ignore. RisCura can help you capitalise on the opportunities it presents.