Asia Insight

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# Is Your China Exposure Optimized?

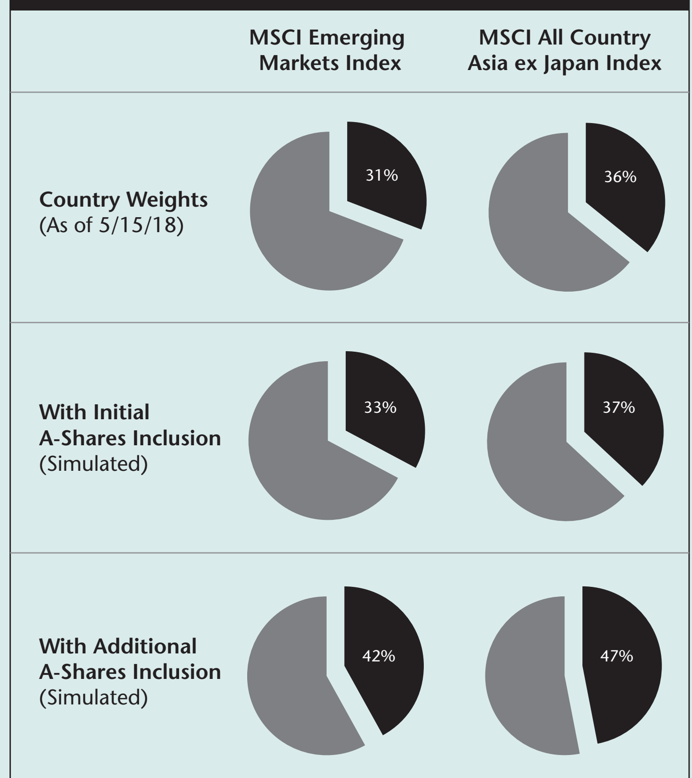
Capturing the growth of the world's second-largest economy, China equities can serve as a core, strategic holding for long-term investors. Yet many investors remain underallocated, despite China's enormous economic output. China currently makes up roughly 31% of the MSCI Emerging Markets (EM) Index, so some investors may think they have adequate China exposure through their EM allocation. Investors often allocate less than 10% of an overall portfolio, however, to emerging markets. Against this backdrop, China may represent only 1% to 3% of a portfolio that is considered to be globally diversified. What's more, many active EM managers are underweight China relative to the benchmark, so investors might have less exposure to China than they intend. Given that the size of China's economy could surpass that of the U.S. within a decade, many investors may need to increase their weight toward China to better align portfolios with long-term goals.

## Tipping Point for Benchmarks

Finding the right weight for China in global portfolios requires assessing the true size of China's economic engine—and the related investment opportunity. Benchmarks have not kept up with China's growth. By definition, benchmarks look backward, while investors look squarely ahead. In China today, venture capital, listed equities and corporate debt all are attracting significant inflows. In 2017, China attracted US$38 billion in venture capital, making it one of the world's largest VC markets, second only to the U.S.[1] The Shenzhen delta, China's Silicon Valley, is home to a significant number of start-ups serving China's domestic markets. Local VC flows are being driven by a Chinese innovation boom, accompanied by record patent filings and increased R&D spending by businesses in China's private sector.

In the case of listed equities, index provider MSCI plans to begin including mainland China stocks (known as A-shares) into the MSCI Emerging Markets Index in phases. On June 1, 2018, MSCI will add 234 large-cap A-shares to the Index, and over time may gradually add securities with a current market cap totaling US$7.5 trillion.[2] At current market values, fuller inclusion of large-cap A-shares would make China an estimated 42% of the MSCI Emerging Markets Index, even using a fairly limited list of A-shares. (See Figure 1.) China's weight in MSCI's regional indexes could grow even larger if MSCI eventually includes mid-cap A-shares and any large-cap A-shares with greater than 30% foreign ownership, both of which are currently excluded.

*Figure 1.* **CHINA'S GROWING ROLE IN BENCHMARKS**




■ China ■ Other countries

Source: MSCI. Data for initial inclusion of A-Shares and additional inclusion of A-shares in MSCI indexes is simulated and based on securities values as of May 15, 2018. Initial inclusion of A-Shares is expected to begin June 2018. As of this writing, MSCI had not yet announced when additional inclusion of A-shares may occur. There is no guarantee any estimates or projections will be realized. Future figures could differ significantly depending on decisions made by MSCI.

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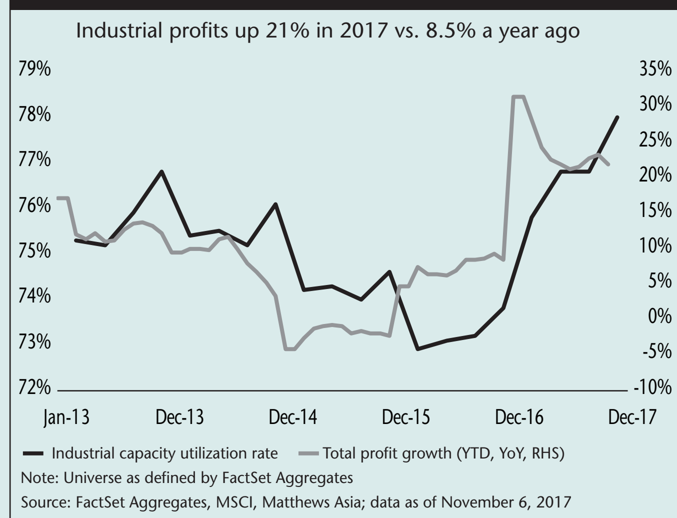
Fuller inclusion of China A-shares into regional indices will likely reshape those indices in the foreseeable future. Over the next five to 10 years, for example, China could become more than 50% of the MSCI Emerging Markets Index. By that point, we expect that the Index would either need to be renamed for its largest constituent (China), or be reconstituted so that China is spun off. This means China would effectively become its own asset class, similar to Japan—a change that would likely be reflected in institutional asset allocation models as well. For investors with time horizons of five to 10 years or longer, increasing allocations to China now, particularly to dedicated China equity strategies, can help shift portfolios toward what commonly used benchmarks may look like in the future.

Turning to China's fixed income markets, the inclusion of Chinese bonds in the Bloomberg Barclays Global Aggregate Index (the "Global Agg"), once fully realized next year, will make the renminbi the fourth-largest currency in the benchmark after the U.S. dollar, the euro and the yen. Significantly, the Global Agg is a developed market index, not an emerging markets index. Based on critical factors in bond investing such as default risk, China is a solidly developed fixed income market. The bond rating agencies of Moody's, S&P and Fitch currently rank China's bond market as A1, A+ and A+, respectively.[3] China government bond yields are also relatively low, reflective of a low risk, inflation and illiquidity premium. Thus, a holistic look at China's capital markets, including China's bond markets, reveals how China is slowly entering developed market benchmarks.

## Where to Invest in China: New Sectors Drive Earnings Growth

Earnings growth in China today is fed by innovation-driven businesses with secular staying power. As China's growing middle class flexes its spending muscle, the country's economy is increasingly dominated by newer, more consumer-driven sectors, including information technology (IT), light industrials, consumer staples, discretionary and health care. These new sectors are driving a surge in corporate earnings. Earnings for all industrials were up 21% in 2017, versus 8.5% in 2016. (See Figure 2.) And these earnings reflect an increase in consumer spending. We have been surprised by the speed at which the smartphone, the internet and 3G/4G technologies seemed to have come at the right time for China. Just when China was developing a consumption and service-led economy, the internet speeded that transition.

*Figure 2.* **CORPORATE EARNINGS IMPROVING IN CHINA**




Note: Universe as defined by FactSet Aggregates

Source: FactSet Aggregates, MSCI, Matthews Asia; data as of November 6, 2017

The earnings story today is about the market composition changing. The old industrials are becoming less important while the new industrials are taking on a bigger role from a macro perspective. As bottom-up, fundamental investors, we see the emergence of sectors such as IT, pharmaceuticals and consumer discretionary. The composition change is important for the earnings turn and we believe earnings are on more solid footing than in previous cycles. Earlier, we saw the earnings cycle in China as cyclical in nature. Now, we are beginning to see less cyclicality in the cycle, in part due to consumer spending.

## Managing the Risks of Rapid Growth

China's rapid economic growth means the country will continue to play an expanding role in global benchmarks. This growth presents both risks and opportunities for investors. Indexes tracking China's equity markets tend to be skewed toward some of the largest companies, creating concentration risk for investors using index funds or exchange traded funds (ETFs) tracking cap-weighted indexes. Both EM and China benchmarks

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alike have a history of significant stock-specific concentration risk. Consider the example of state-owned banks in the mid/late-2000s dominating the indexes. Fast forward to today when private, entrepreneurial information technology (IT) companies now represent some of the biggest names in the indexes. In addition, China’s A-share market is still largely driven by retail investors, creating potential for higher volatility than markets dominated by institutional investors. Investors will also need a keen understanding of the differences between state-owned enterprises (SOEs) and the private sector as the private sector has historically done a better job of allocating capital and generating attractive shareholder returns. Key components of an active approach to security selection may include determining which A-shares to own, which mega-cap names to own, which SOEs to own (and which to avoid) and which private enterprises are most promising. Thus, we believe a bottom-up, fundamental approach to investing in China is essential.

An active approach to security selection can help manage risks in markets, such as China, that are still inherently inefficient. In our view, corporate governance is a good place to start a discussion of risk management because many risks stem from weakness in governance oversight at the company level. Important questions related to governance include: Who are the owners of the firm and what is the track record of its management team in creating and returning shareholder value? Are a company’s margins or working capital turnover significantly different than the other peers in the industry? Do cash flows tell the same story as earnings? Do companies report large amounts of cash on their books and yet make below-market interest income out of the cash? Do suppliers and customers confirm what a company is publicly reporting about its business? MSCI currently ranks China’s corporate governance practices as being in line with the median for its All Country World Index.[4] Even in fully developed markets, governance issues continue to occasionally bedevil investors. Examining governance structures is an especially important benefit of active management in a rapidly growing market such as China.

## A Dedicated Allocation to China

A dedicated allocation to China can help investors fine-tune and recalibrate how they gain access to the world’s fastest-growing economy, while improving global diversification. As a core portfolio holding, China equities can comfortably sit alongside such portfolio staples as U.S. and EAFE (Europe, Australasia and the Far East) investment strategies. Looking ahead, we expect earnings growth in China to be increasingly driven by innovation and consumer-driven sectors. As the spending power of China’s middle class continues to grow, sectors such as health care, travel and leisure and consumer services will play a much greater role in fueling China’s economic engine. Accordingly, we believe that an effective way to capture the future of China’s growth is through a dedicated allocation to China that employs an active approach to security selection. Given China’s growth potential, we believe investors can benefit from considering China strategies that are forward-looking by design, seeking to capture China’s future, rather than its past. At Matthews Asia, we have been investing in China for more than 20 years. During that time we have seen dramatic transformations. As we look to the next 20 years of investing in China, we will continue to employ a flexible, bottom-up approach across our China strategies.

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***About the Author***
*For more than two decades, Andrew Mattock, CFA, has been managing investment strategies that seek to capture the growth of Asia equities. He has been Lead Manager of the Matthews China Strategy since April 2015. A Chartered Accountant, Andrew lives in the Bay Area and frequently travels to China to meet management teams of our portfolio companies, as well as their vendors, suppliers and customers.*

1 The Wall Street Journal, “Silicon Valley Powered American Tech Dominance—Now It Has a Challenger,” April 12, 2018
2 MSCI, “MSCI Equity Indexes May 2018 Index Review”
3 Country rating for China’s bond market as of May 15, 2018. Source: Tradingeconomics.com.
4 MSCI, Corporate Governance in China, September 2017

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**Definitions**

**MSCI Emerging Markets (EM) Index:** A free float-adjusted market capitalization-weighted index of the stock markets of Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Russia, Qatar, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

**Bloomberg Barclays Global Aggregate Bond Index (Global Agg):** An index of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

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