



# Demystifying China Webinar

July 29, 2020

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## Presenters



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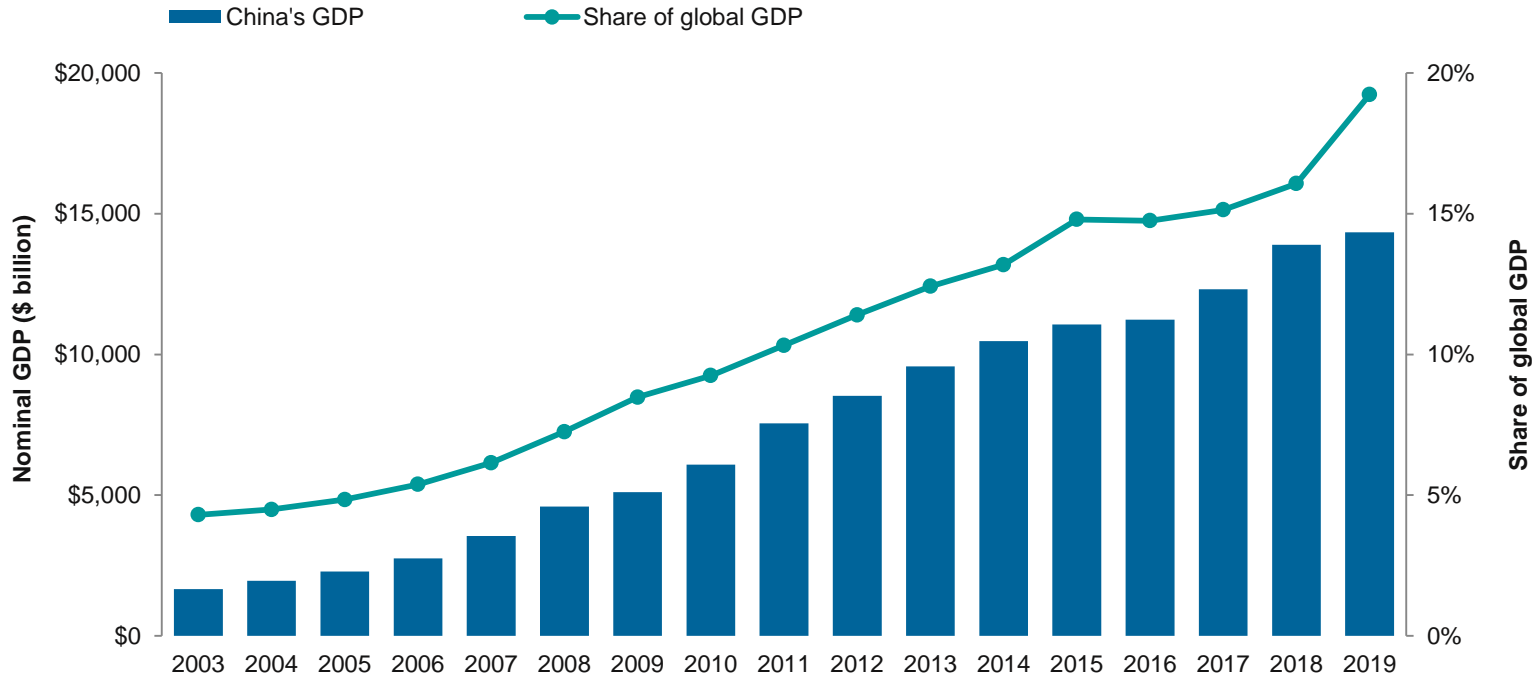
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## China's Economic Growth Story

Fanglue Zhou

# China's Economic Growth

Fast rise in the past two decades



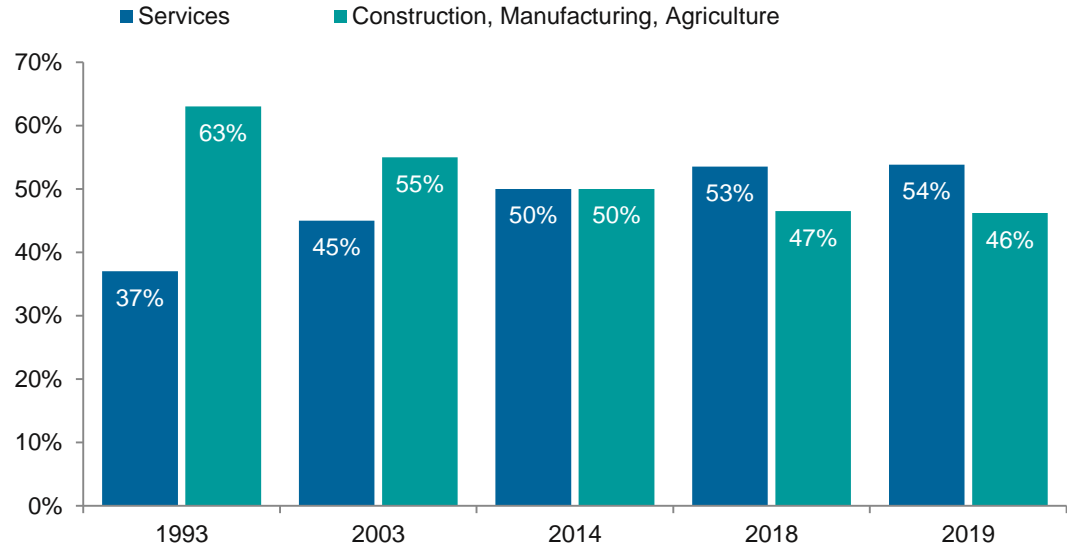
Source: WorldBank, OECD; China's share of global GDP in 2019 is IMF estimate

# China's Economic Growth

Transformation from a manufacturing-reliant economy to one led by services

- Since 2014, more than 50% of China's GDP has come from services
- Over the past five years, China lost 14 million manufacturing jobs but gained over 70 million service jobs

Composition of China's GDP



Sources: China National Bureau of Statistics, Thomson Reuters.  
Chart shows average of the trailing four quarters. As of 12/31/2019.

# China's Economic Growth

Rising incomes will benefit consumption domestically and globally

- Rising incomes for local workers have benefited domestic consumption in China. In 2018, domestic consumption accounted for 76% of China's economic growth
  - Impact of U.S.-China trade war would be modest
- As of 2019, China made up 19% of the global population and drove 9% of global consumption
  - Mainland China is the major revenue source for many multinational companies

## Mainland China is the ...

primary revenue source for:



second-largest revenue source for:

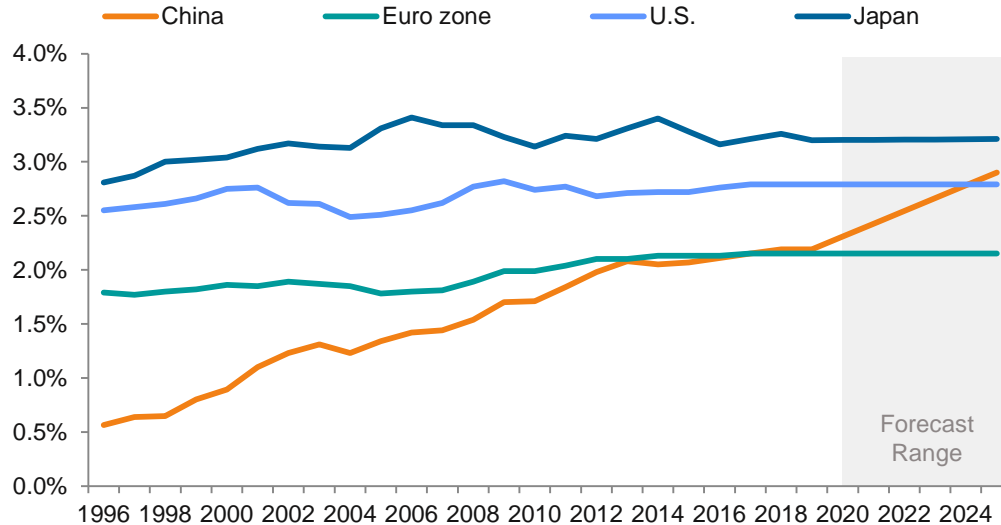


Sources: International Monetary Fund, data as of 3/31/2019; China National Bureau of Statistics, Thomson Reuters

# China's Economic Growth

Technology and innovation fueled the next chapter of China's growth story

## R&D Spending as a Percent of GDP



- “Made in China 2025”
  - Technologically self-sufficient and high-tech powerhouse
  - Targeting health care, industrial automation, semiconductors, and clean energy
- China expected to have 150 million 5G users by the end of 2020
- Electric vehicles continue to grow
  - China had half of world's EV stock in 2018
- Productivity solutions with automation
  - For example, China's robot installations are the highest in the world



Source: World Bank Group, PineBridge Investments. Calculations as of July 21, 2020

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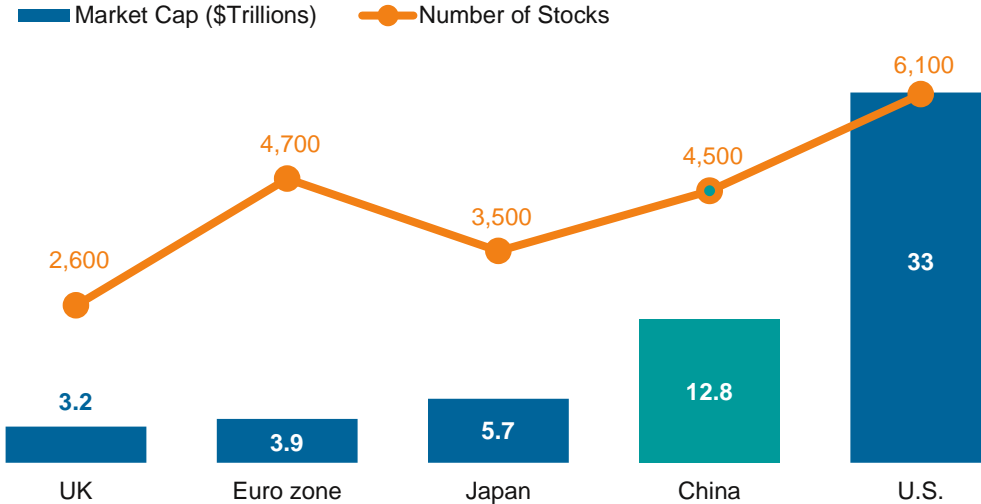
## **China's Equity Markets: Key Opportunities and Risks**



# China's Equity Market

Large and liquid equity market

## Size of Major Equity Markets

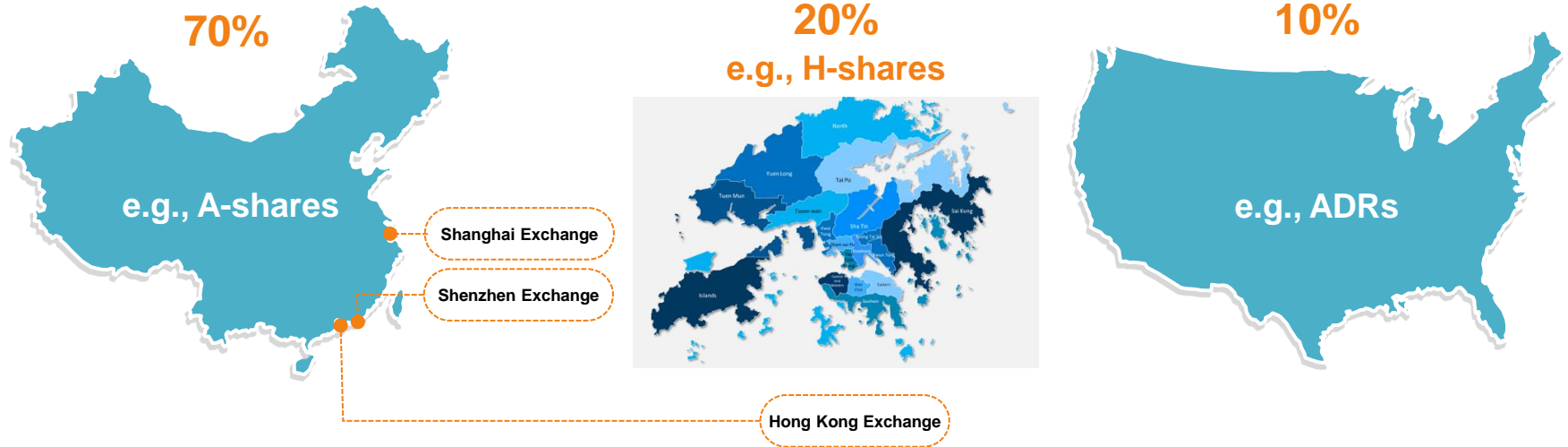


- In a mirror to the size of its economy, China also has the world's second-largest equity market by value
- More than 4,000 publicly traded companies are listed in China

Sources: Callan, MSCI

# A Closer Look at China's Equity Market

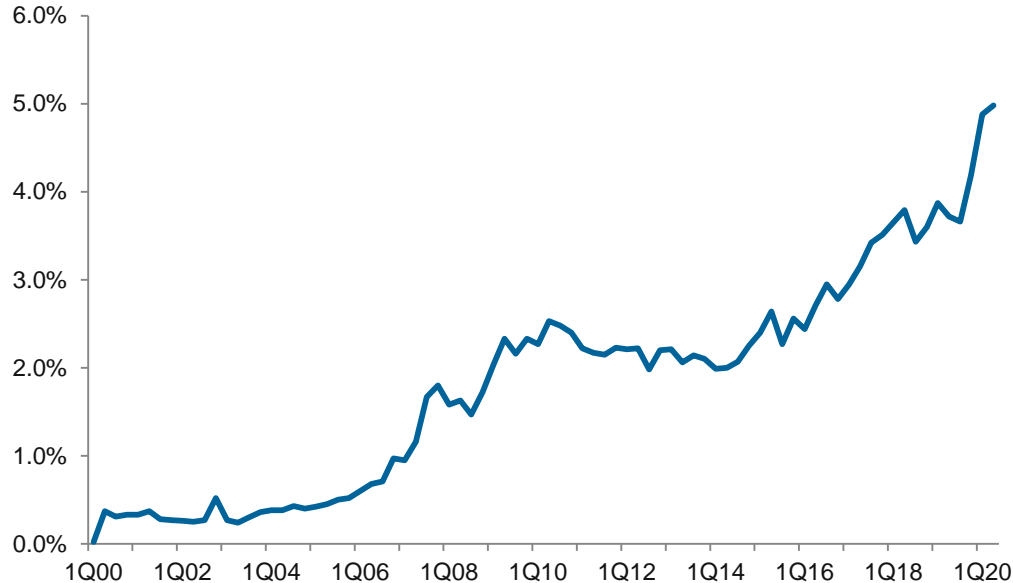
Understanding Chinese equity share classes



# Why Should You Care About China's Equity Markets?

A growing presence in global equity markets

China's Weight in the MSCI ACWI Index



- The MSCI ACWI Index is designed to represent the full opportunity set of large- and mid-cap stocks in global equity markets
- China was added to the MSCI ACWI in March 2000 with an initial allocation of 0.02%
- China now represents 5% of the MSCI ACWI as of 1Q20, surpassing the U.K. and becoming the third-largest country after the U.S. and Japan
- In the same time period, China's weight in the emerging market index has grown from 0.3% to 41%

Sources: Callan, MSCI

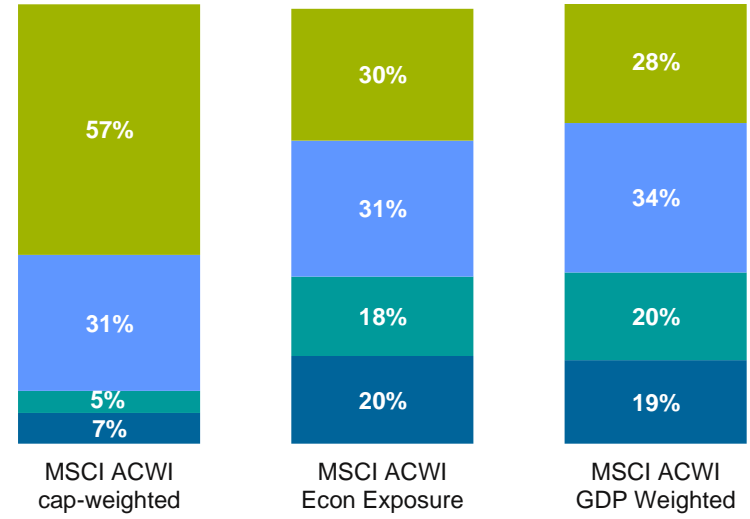
# Why Should You Care About China's Equity Markets?

## Ways to slice the world

- U.S. and China combined represent over 45% of global GDP and economic exposure
- China's 5% representation in the cap-weighted MSCI ACWI is much lower than its GDP or economic exposure weight

### The View of MSCI ACWI

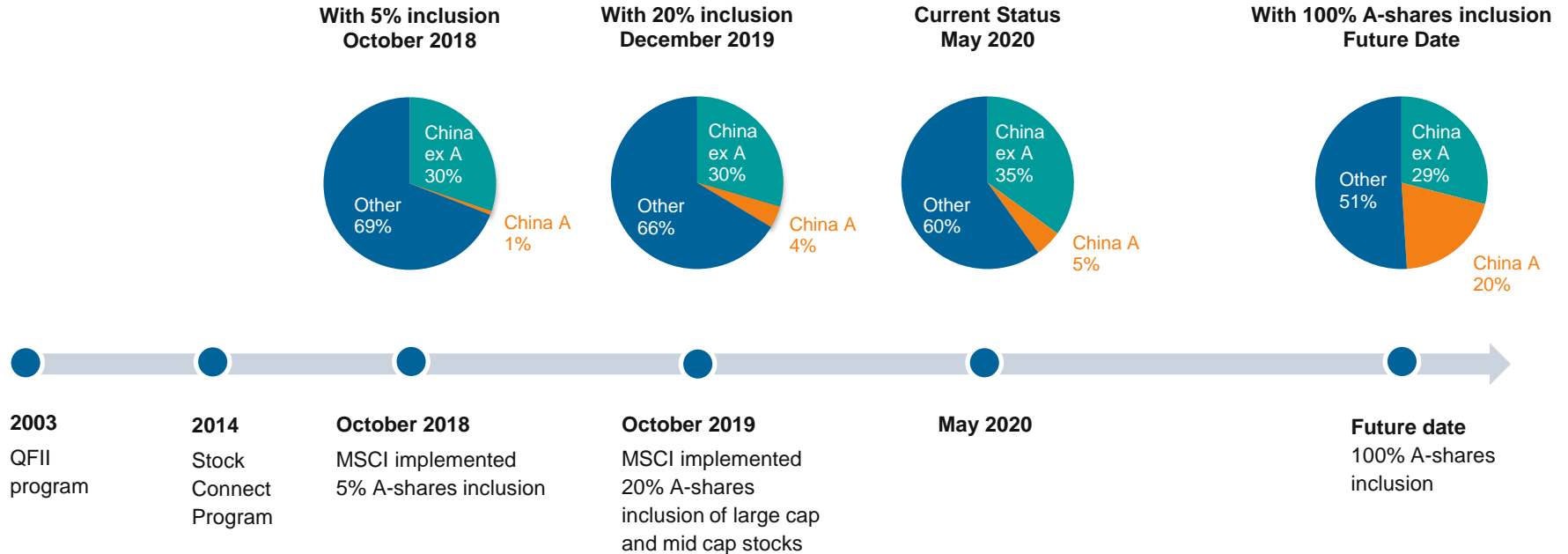
■ EM ex China ■ China ■ Developed ex U.S. ■ U.S.



Sources: Callan, MSCI (as of March 31, 2020)

# China's Weight Continued to Grow in Major Indices

With full inclusion of China A-Shares, China is expected to become ~50% of the MSCI EM Index

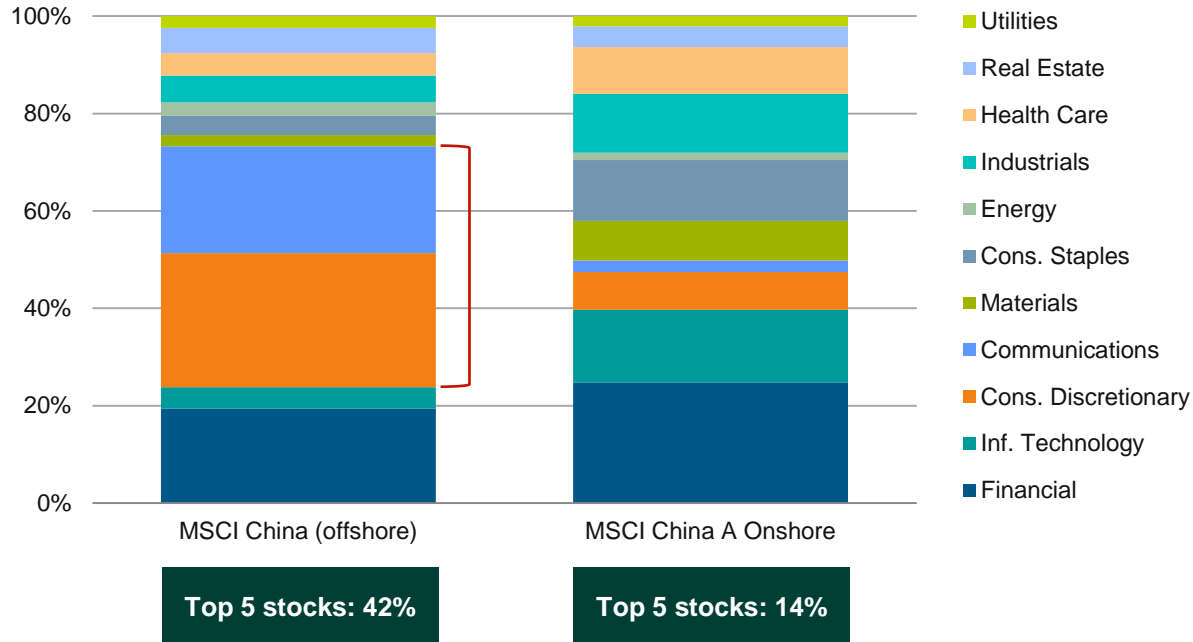


Sources: Callan, MSCI

# What Are the Opportunities?

China's A-shares market offers a more diversified sector exposure

## Sector Weights

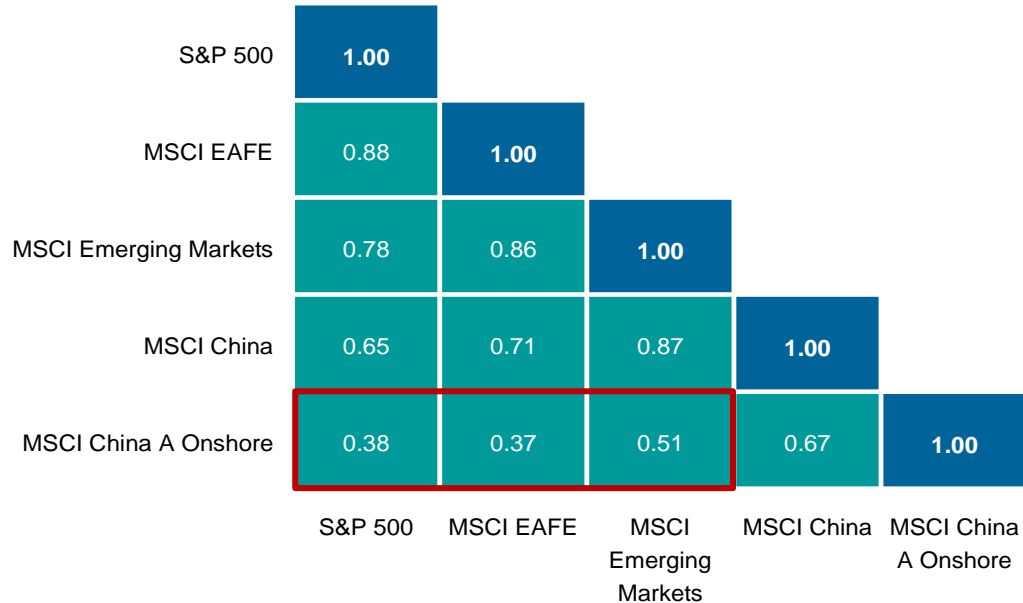


Sources: Callan, MSCI

# What Are the Opportunities?

China A-shares equity offers relatively low correlation with other equity markets

Monthly performance correlation for 11 1/4 Years Ended March 31, 2020



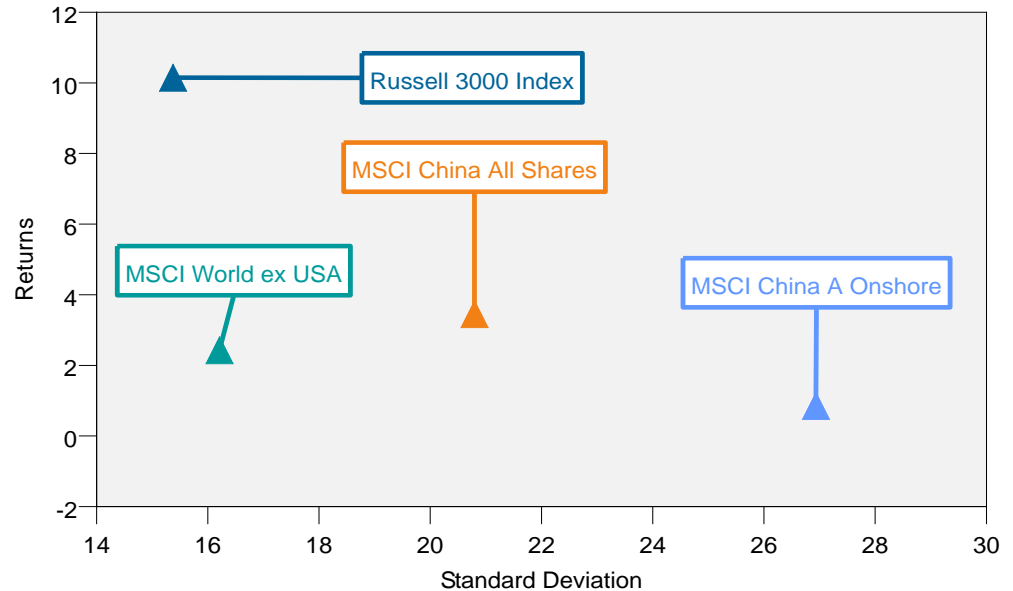
Source: Callan

# What Are the Key Challenges?

China's equity markets are volatile

- Chinese equities are more volatile than other major equity markets
- Heavy retail participation in the A-shares market can potentially create significant volatility

Scatter Chart for 10 Years Ended March 31, 2020



Source: Callan



# What Are the Key Challenges?

## Operational complexity

- Market accessibility is limited
- Trade suspensions
  - During the correction of 2015, 56 large cap, 76 mid cap, and 794 small cap securities were suspended
- Limited number of products in the manager universe and active management fee can also be high



Source: Callan

## What Are the Key Challenges?

Geopolitical tension between U.S. and China might become the new normal

- Trade war
- Hong Kong
- Rule of law
  - Human rights
  - Corporate governance and state-owned enterprises





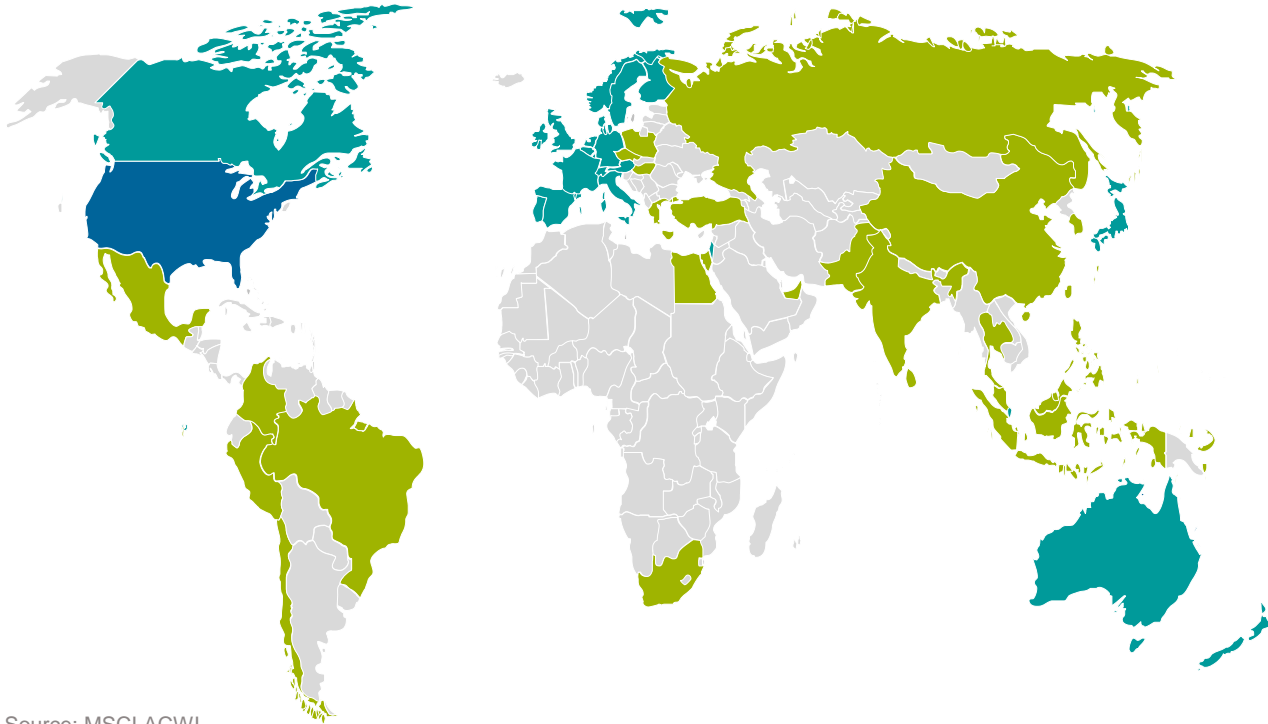
- China has the second-largest economy and capital market in the world, yet it is under-represented in global indices
- China's A-shares market is large and liquid and offers diversification benefits
- Investors need to be aware of the challenges around operational complexity and headline risks

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## How Do You Incorporate an Allocation to China?

Ho Hwang

# Global Equity Structure



## United States

### Developed ex-U.S.

Australia	Hong Kong	Portugal
Austria	Ireland	Singapore
Belgium	Israel	Spain
Canada	Italy	Sweden
Denmark	Japan	Switzerland
Finland	Netherlands	U.K.
France	New Zealand	
Germany	Norway	

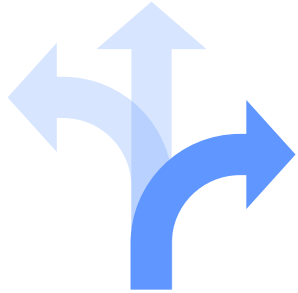
### Emerging Markets

Argentina	India	Russia
Brazil	Indonesia	Saudi Arabia
Chile	Malaysia	South Africa
China	Mexico	South Korea
Colombia	Pakistan	Taiwan
Czech Republic	Peru	Thailand
Egypt	Philippines	Turkey
Greece	Poland	UAE
Hungary	Qatar	

Source: MSCI ACWI

# Global Equity Structure

## Path 1: Status quo



**United States**

**Developed ex-U.S.**

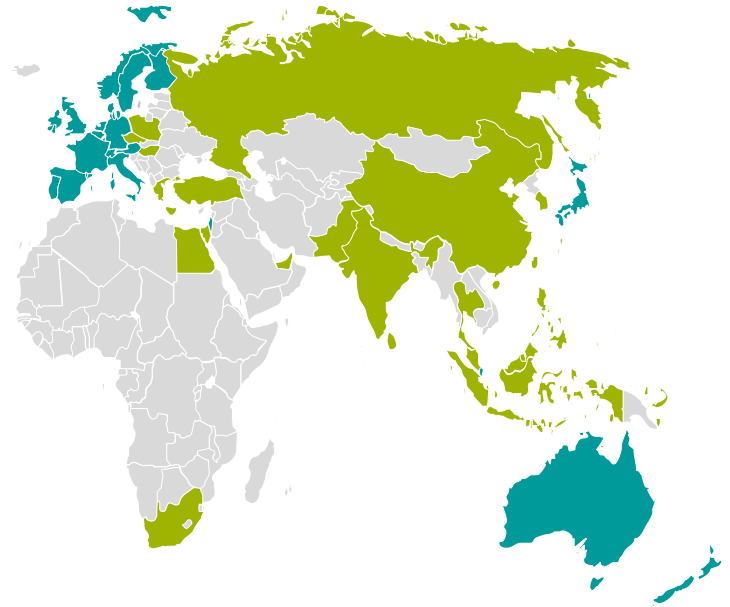
**Emerging Markets**  
(includes China)

### Merits

- Low disruption
- Low cost
- Low operations / compliance risk

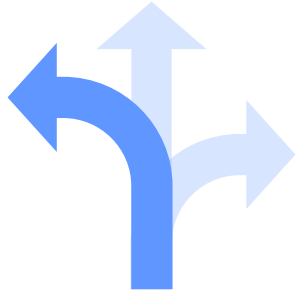
### Considerations

- Underexposure to China
- Confined to large / mid cap companies
- Exposure managed by generalists

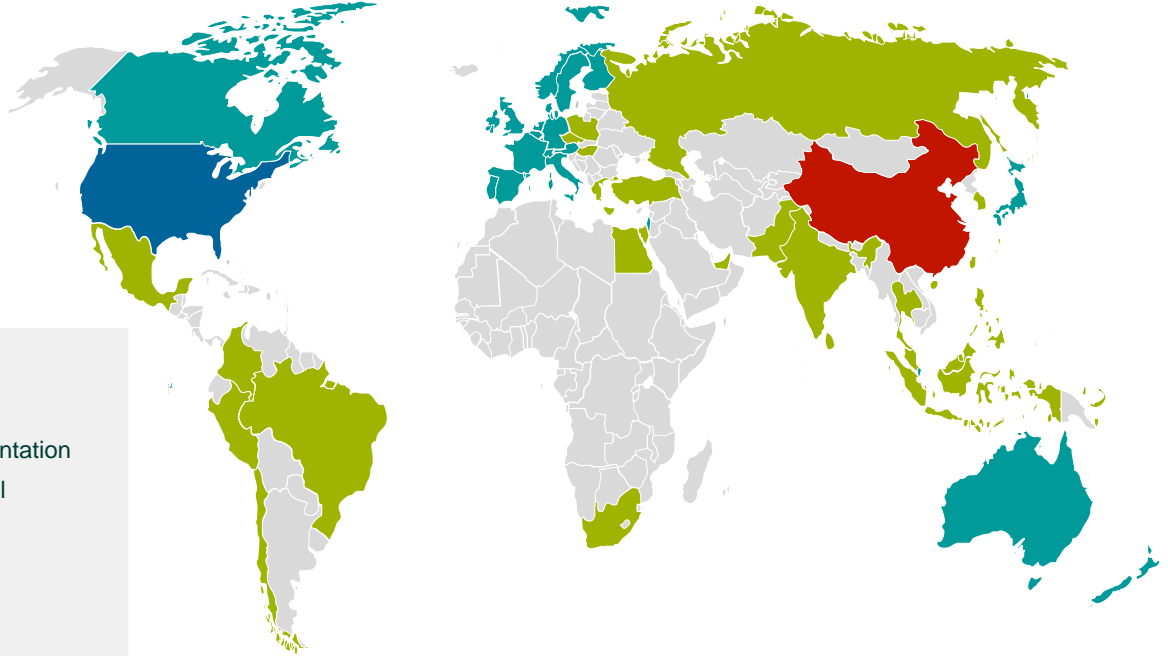


# Global Equity Structure

## Path 2: Bridge



**United States**  
**Developed ex-U.S.**  
**Emerging Markets**  
**+ China A**



### Merits

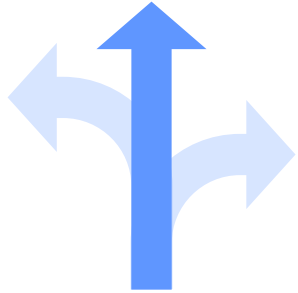
- Dedicated allocation to China A
- Exploit the full breadth of investable universe
- Allocation managed by specialists

### Considerations

- Overlap risk
- Cost of implementation
- Adds operational complexity

# Global Equity Structure

## Path 3: 'Final' destination

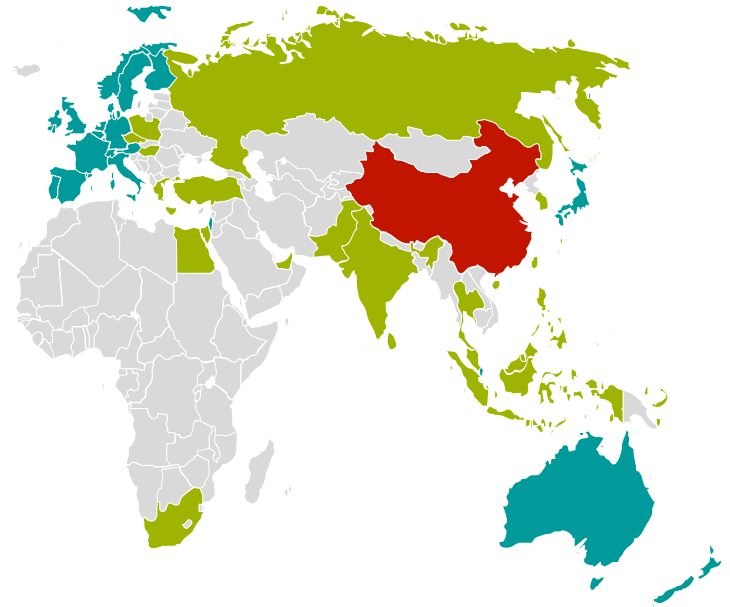


**United States**

**Developed ex-U.S.**

**Emerging Markets** (ex China)

**China All**



### Merits

- Dedicated allocation to China All
- Allocation managed by specialists
- Valuation arbitrage opportunity between Chinese share classes

### Considerations

- Limited manager universe
- Cost of Implementation
- Adds disruption and operational complexity

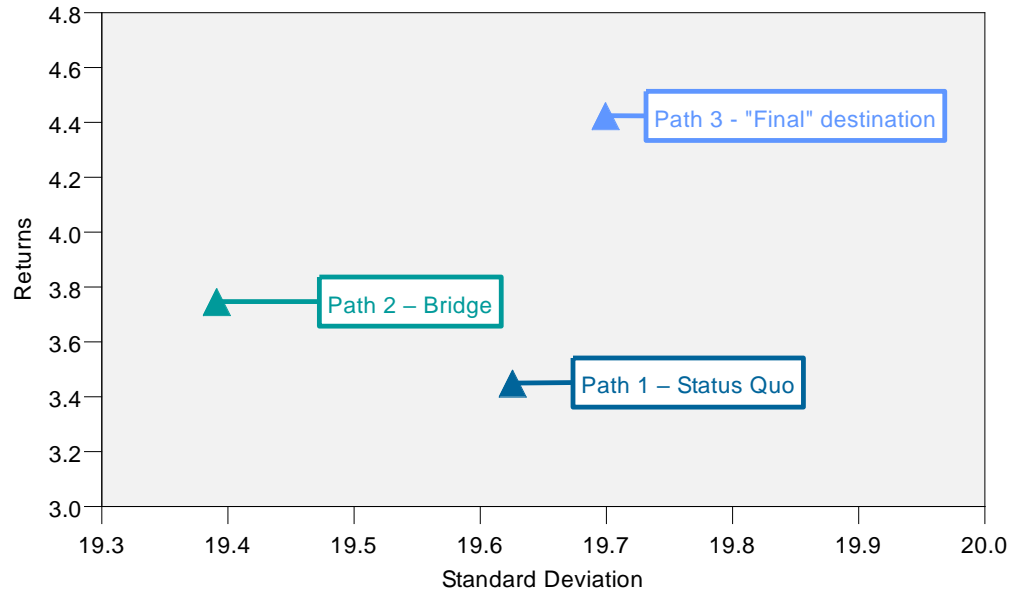


# Global ex-U.S. Equity Structure

## Risk / return of three paths

- Risk / return of global ex-U.S. equity structure may be enhanced by recalibrating regional exposure
- Dedicated allocation to China has boosted risk / return of global ex-U.S. equity structure
- Path 3 – “Final” destination has achieved the highest risk / return relative to other paths

Scatter Chart for 19 1/4 Years Ended March 31, 2020



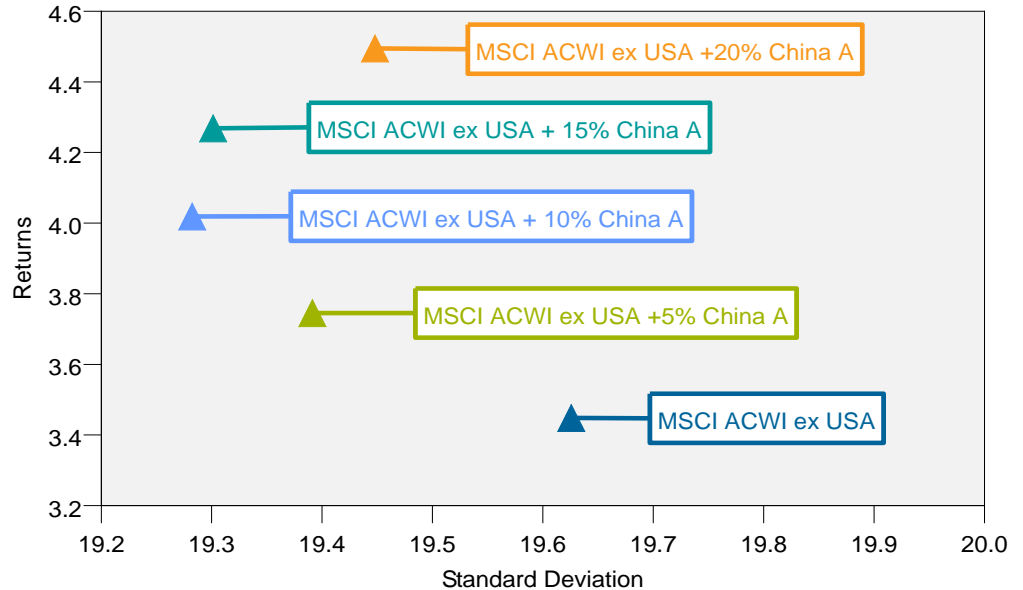
Sources: Callan, MSCI

# Global ex-U.S. Equity Structure

What is the 'optimal' allocation?

- Allocation to China A has improved the risk / return profile of the global ex-U.S. equity structure
- Sharpe Ratio has peaked when China A allocation is between 5% and 10%
- Risk / return benefits historically have decelerated after 10% China A allocation

Scatter Chart for 19 1/4 Years Ended March 31, 2020



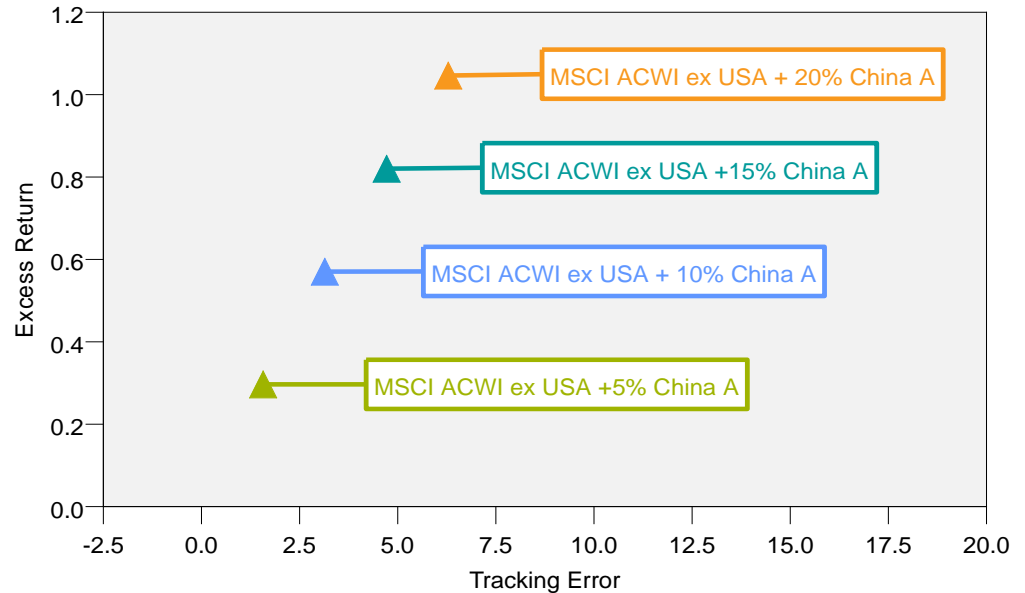
Sources: Callan, MSCI

# Global ex-U.S. Equity Structure

What is the 'optimal' allocation?

- Allocation to China A has enhanced risk-adjusted returns for the global ex-U.S. equity structure
- Information Ratio has been maximized when China A allocation is between 5% and 10%
- Risk / return benefits have decelerated after 10% China A allocation

Scatter Chart for 19 1/4 Years Ended March 31, 2020



Sources: Callan, MSCI

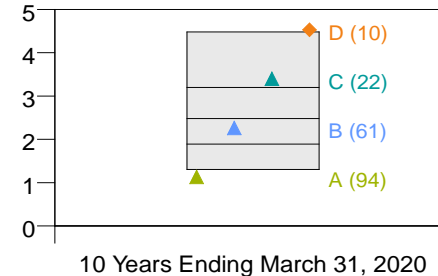
# Global ex-U.S. Equity Structure

## Tracking error with China A allocation

- Public pension plans generally had about 2.5% active risk within their global ex-U.S. equity structure over the past 10 years
- Allocation to China A had a notable impact on the tracking error of the global ex-U.S. equity structure without introducing maverick risk

### Global ex-U.S. Equity Tracking Error

Group: Callan Public Fund Sponsor Database



10th Percentile	4.48
25th Percentile	3.20
Median	2.48
75th Percentile	1.89
90th Percentile	1.30

MSCI ACWI ex USA + 5% China A	▲ A	1.13
MSCI ACWI ex USA +10% China A	▲ B	2.27
MSCI ACWI ex USA +15% China A	▲ C	3.40
MSCI ACWI ex USA +20% China A	◆ D	4.53

Sources: Callan, MSCI

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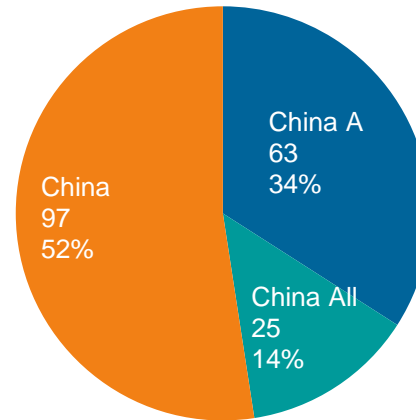
## **China A Manager Universe**

# Manager Universe

## Composition of China A manager universe

- Approximately 80% of the China A products in the database are managed by offshore managers
  - Product formation has been accelerated since the inclusion of China A by index providers
- Fundamentally driven China A strategies constitute around 87% of the universe
- Stylistically the manager universe consists of 51% growth, 28% core, and 21% value

Number of Products



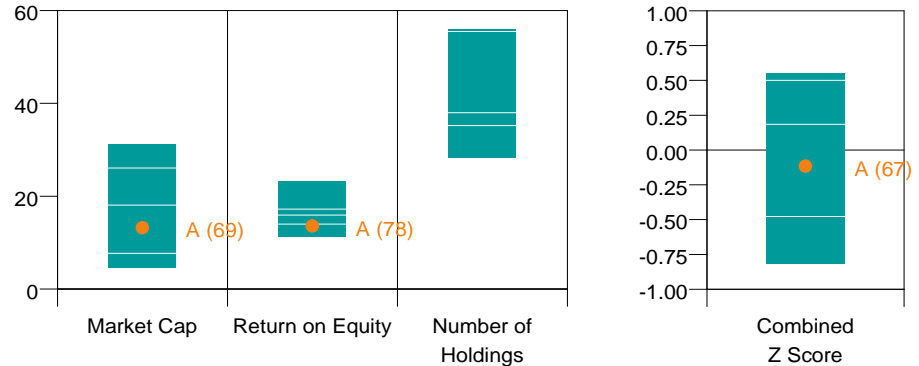
Based on Callan and eVestment databases as of March 31, 2020

# China A Manager Universe

## Holdings-based characteristics

- China A managers tend to share the following characteristics:
  - Large market bias
  - Higher quality
  - Focused portfolios
- China A strategies are generally conviction-driven with top 10 holdings making up more than 50% of the portfolio

Statistics as of March 31, 2020  
Group: Callan China A Onshore



10th Percentile	31.18	23.24	56.00	0.56
25th Percentile	26.08	17.22	55.50	0.50
Median	18.08	15.94	38.00	0.19
75th Percentile	7.72	14.00	35.25	-0.48
90th Percentile	4.48	11.27	28.40	-0.81
MSCI China A Onshore ● A	13.21	13.59	670.00	● A -0.12

Source: Callan

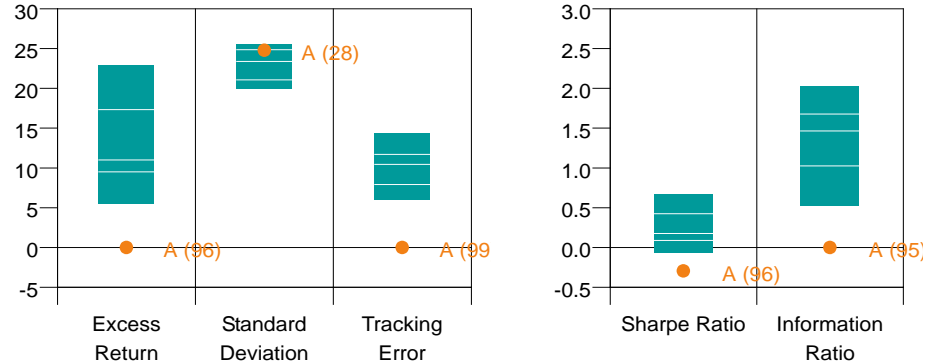
# China A Manager Universe

## Returns-based characteristics

- China A managers tend to share the following characteristics:
  - Outsized excess return
  - Sizable tracking error
  - Lower volatility than the market
- Fertile ground for active management with compelling risk-adjusted return

### Statistics for 5 Years Ended March 31, 2020

#### Group: Callan China A Onshore



	Excess Return	Standard Deviation	Tracking Error	Sharpe Ratio	Information Ratio
10th Percentile	22.92	25.60	14.32	0.67	2.02
25th Percentile	17.35	24.88	11.72	0.43	1.68
Median	11.01	23.40	10.47	0.18	1.47
75th Percentile	9.52	21.08	7.92	0.09	1.03
90th Percentile	5.49	20.02	5.96	-0.07	0.52
MSCI China A Onshore ● A	0.00	24.81	0.00	-0.29	0.00

Source: Callan

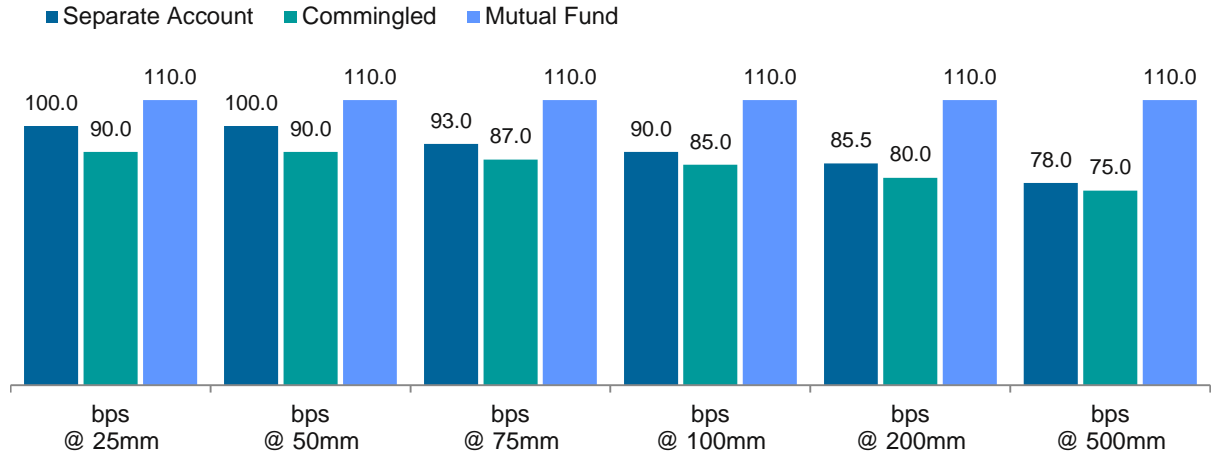


# China Manager Universe

Don't be shocked by the sticker price

- Onshore China A managers tend to have higher standard fees than offshore managers
- Some offer performance-based fee with 20 bps - 60 bps management fee and 12.5% - 20% incentive fee
- Founders fee ranging from 30 bps to 75 bps available for seed investors willing to launch a pooled vehicle

Median Standard Fee Schedule by Vehicles



Based on Callan and eVestment databases as of March 31, 2020

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## China A Search Activity

### Close, but no cigar

Executed two China A searches over the past three years

- Asset owner seeking to complement its emerging market structure
  - Tabled the search as tensions between the U.S. and China escalated after identifying and conducting finals interviews
- Asset owner exploring opportunity in China with an RFP process
  - More than 80 China A and China All managers responded to the RFP
  - Asset owner may have decided not to pursue the asset class due to operational and compliance concerns

Year-to-date, two pension plans have inquired about China A managers



- Allocation to China has primarily three paths: “status quo,” “bridge,” and “final destination”
- Dedicated allocation to China offers favorable return and diversification benefits
- China A is a fertile ground for active management
- China A searches have not led to allocations due to non-investment reasons

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## Biographies

**Ivan "Butch" Cliff, CFA**, is an executive vice president and director of research, responsible for the Global Manager Research and Capital Markets Research groups. Butch is a member of Callan's Management, Client Policy Review, Institute Advisory, Alternatives Review, and Editorial committees. He is also a portfolio manager and member of the investment committee that oversees all of Callan's discretionary multi-manager solutions. He is a shareholder of the firm and is a holder of the right to use the Chartered Financial Analyst® designation.

**Ho Hwang** is a vice president and a non-U.S. equity investment consultant in the Global Manager Research group. He is responsible for research and analysis of non-U.S. equity investment managers and assists plan sponsor clients with non-U.S. equity manager searches. Ho regularly meets with investment managers to develop an understanding of their strategies, products, investment policies, and organizational structures. He serves on Callan's Inclusion Committee and is a shareholder of the firm. He is a Level II candidate in the CFA Program.

**Fanglue Zhou** is a vice president in Callan's Independent Adviser Group (IAG). Fanglue is responsible for investment manager due diligence and assists in all aspects of analytical support, including strategic planning, manager structure, and performance measurement for various financial intermediary clients. Fanglue is a shareholder of the firm. She's a Level II candidate in the CFA Program.



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