

June 2018

China A-Shares: Key Issues for Investors to Consider

KEY ELEMENTS

- China is taking steps to open up its securities markets to a wider range of non-Chinese institutional investors, and major index providers are increasing the proportion and types of Chinese shares in their indices.
- In particular, expanded access to China A-shares creates new opportunities for investors to participate in the transition of the Chinese economy toward a services-led model. Investing in China A-shares is a fertile ground for active management to potentially generate uncorrelated positive excess returns.
- But investing in China presents a set of risks that range from the country's slowing GDP growth to stock trading suspensions. Although China A-shares present an attractive opportunity, implementation is challenged by a shallow manager universe and high fees.



“The A-shares market includes over 3,000 securities with a market value of over \$8.5 trillion, and it provides an avenue to gain broad exposure to the Chinese economy.”

Rufash Lama, Analyst
Global Manager Research



China is the world's second-largest economy, behind the United States, and it is expected to take the lead by 2030.

The meteoric rise of China's economy has transformed the nation from a predominantly agrarian society into an industrial powerhouse. From 1980 to 2017, China's GDP grew at an average annual rate of 9.6%¹, lifting hundreds of millions of people out of extreme poverty.² This growth has made China the world's second-largest economy, behind the United States, and it is expected to take the lead by 2030.³ It plays an important role in the global economy and is developing various economic initiatives to boost international and interregional trade. For example, the "One Belt One Road" (OBOR) initiative was launched in 2013 to promote opportunities for China to partner and trade with over 60 countries for economic development.⁴

China is now going through a transitory phase, and the government has taken measures to shift the economy away from its traditional sources of growth—resource-intensive manufacturing and fixed investment—toward a services-led model to expand domestic consumption and innovation. These reforms are expected to drive long-term sustainable growth.

This next phase in China's economy may also provide opportunities for foreign institutional investors as the country takes steps to open up its securities markets to non-Chinese entities. Investment managers are creating strategies to take advantage of this opening, and major index providers are starting to expand their products to include a wider range of Chinese equities. The shift within the Chinese economy is expected to lead to new types of Chinese companies that are less dependent on resource-intensive industries and more attuned to the "new economy" of services and technology.

Building Bridges

Until fairly recently, global investors could not gain meaningful exposure to Chinese equity markets due to government-imposed capital controls and lack of access. Prior to 2003, foreign investors were able to trade only a limited set of mainland Chinese companies listed on the Hong Kong Stock Exchange (known as H-shares). The Qualified Foreign Institutional Investor (QFII) program was launched in 2003 to provide limited access (through quotas) to China A-shares, which are ownership stakes in Chinese companies that trade on the Shanghai and Shenzhen stock exchanges and are quoted in renminbi, the Chinese currency.

A significant step was taken in 2014 with the launch of the Shanghai-Hong Kong Stock Connect Program, followed by the Shenzhen Connect Program in 2016. These efforts improved access to China A-shares; foreign investors can buy over 1,500 Shanghai- and Shenzhen-listed stocks without applying for a license and without a quota. These programs allow foreign investors to trade through their own local brokerage and clearing facilities.

Following these steps—and with broad support from institutional investors—MSCI decided in June 2017 to include China A-shares in its Emerging Markets Index, after declining to do so for three consecutive years. Factors that led to the change were improved accessibility, a reduction in the number of trading

1 International Monetary Fund, <http://www.imf.org/external/pubs/ft/weo/2018/01/weodata/index.aspx>

2 The World Bank, <http://povertydata.worldbank.org/poverty/country/CHN>

3 Angus Maddison Research

4 China-Britain Business Council, [http://www.cbcc.org/resources/belt-and-road-reports-\(1\)/](http://www.cbcc.org/resources/belt-and-road-reports-(1)/)

suspensions, and the easing of requirements for investment vehicles linked to indices. The inclusion will go through a two-step process and involve 234 large-cap A-shares. The first phase in June 2018 will result in China A-shares representing 0.37% of the MSCI EM Index. The second phase in September 2018 is expected to increase the weight of China A-shares to 0.73%.⁵ However, total China exposure may reach 40% because the Index already includes offshore Chinese stocks such as Alibaba (U.S.) and Tencent (Hong Kong). The inclusion factor may increase in the future if trading standards and other conditions, such as repatriation restrictions and foreign ownership limits, continue to improve.

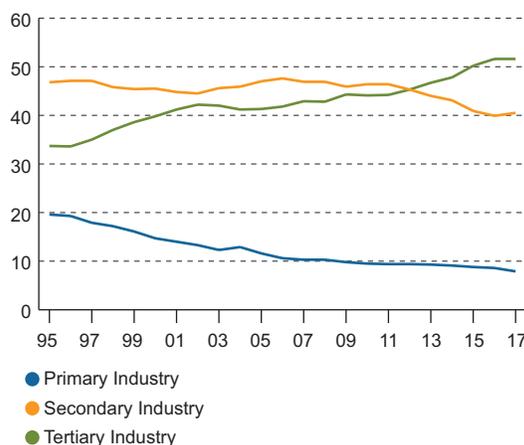
Industrial Evolution

China's large supply of labor and relatively low wage rates allowed it to emerge as the world's largest exporter of manufactured goods. However, this competitive advantage in low-cost manufacturing has eroded due to rising wages, driven by an aging population and slowdown in the growth of its labor force.⁶ To address this decline and to promote China's future economic growth, authorities implemented reforms to rebalance the economy toward consumption and services.

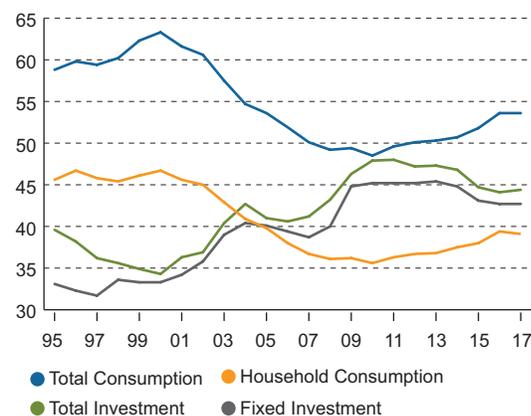
China's so-called "tertiary industry[†]," which includes the consumer and services sectors, has been the largest component of its GDP since 2012 (**Exhibit 1**). This industry has been a significant source of job creation and is expected to take an even larger share of China's "new economy" as the country focuses on consumption.⁷

Exhibit 1
Structural Changes
in China's GDP

Contribution to GDP (%) by Industry[†]



Expenditure as a Percent of GDP (%)



[†] Primary industry is concerned with the extraction and collection of natural resources. Secondary industry includes sectors focused on construction and goods production. Tertiary industry includes sectors that provide services to consumers such as transport, hotels and catering, and financial intermediation, among others.

Sources: CEIC, Morgan Stanley Research, UBS

5 MSCI

6 Michael Hasenstab, Global Macro Shifts. Franklin Templeton Institutional

7 UBS, *Chinese Equities: Over the Great Wall*, 2017

Household consumption has made a big contribution to China's GDP growth since 2015, as total investment and net exports (the other two components of GDP) have fallen, and it has exhibited an average annual growth rate of 8.9% over the last 10 years, the highest among major economies. This has been attributed to China's burgeoning middle class, which is expected to reach over 350 million by 2030.⁸ This growth in income and purchasing power is expected to favor new-economy sectors such as technology, health care, and financial intermediation. With the opening of the China A-shares market, these new-economy Chinese equities will also now become more accessible to foreign investors.

Under the Hood

China's equity market is the second-largest in the world measured by market value, and it has grown rapidly since it opened in 1991. There are over 4,000 publicly traded Chinese securities with total market capitalization in excess of \$12 trillion.

Until the recent changes, global investors could only access a small number of Chinese companies listed outside of China, including prominent names such as Alibaba and Tencent. These multinational Chinese companies represent the offshore market. Listed as H-shares on the Hong Kong Stock Exchange or as ADRs in the United States, these stocks have historically catered to foreign investors.⁹ ADRs are dominated by companies in the Information Technology sector. H-shares represent some of the large state-owned enterprises (SOEs) in the Banking and Energy sectors.

China's growing onshore A-shares market represents a much larger and more diverse opportunity set. The A-shares market includes over 3,000 securities with a market value of over \$8.5 trillion. It is diversified across sectors and provides an avenue to gain broad exposure to the Chinese economy. Many companies in the China A-shares market tend to be privately owned (as compared to SOEs) and operate in "new economy" sectors like Health Care and Information Technology (**Exhibit 2**).¹⁰ Compared to SOEs, which are concentrated in China's old economy sectors such as Industrials and Energy, privately owned firms tend to be more profitable and have healthier debt-to-asset ratios. The onshore market has been a preferred listing venue for many emerging Chinese companies because they have been able to gain premium valuations in a relatively liquid market. Based on estimates from investment managers, the onshore market has high average daily liquidity and some of the tightest bid/ask spreads in the global equity markets.

The A-shares market as represented by the MSCI China A Index, which includes roughly 400 large and mid-cap companies listed on the Shanghai and Shenzhen exchanges that are accessible through the stock connect programs, has historically exhibited low correlation to other global equity benchmarks (**Exhibit 3**). This could provide long-term global investors an opportunity to diversify their portfolios and improve risk-adjusted returns.

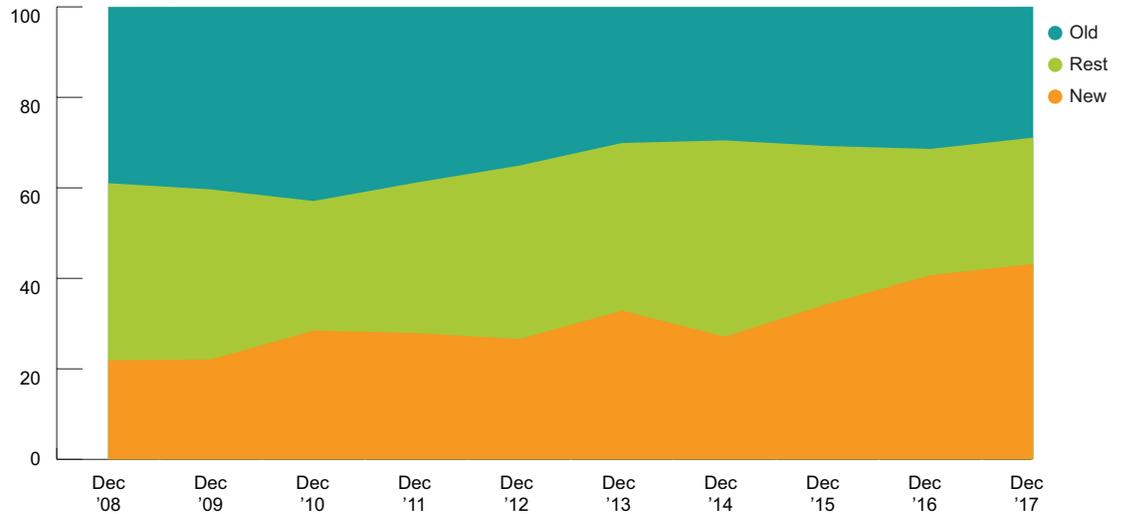
8 The Brookings Institution, *The Unprecedented Expansion of the Global Middle Class*, 2017

9 ADRs: American Depository Receipts represent a specified number of shares in a foreign corporation.

10 UBS, *Chinese Equities: Over the Great Wall*, 2017

Exhibit 2

Shift in Industries in China A-Shares Index



Old Economy Sectors: Energy, Materials, Industrials. **New Economy Sectors:** Consumer Discretionary, Consumer Staples, Health Care, Information Technology, Real Estate. **Rest:** Financials, Telecom Services, Utilities

Sources: Morgan Stanley Research, MSCI

Exhibit 3

Correlations of Major Indices with China A-Shares

- Correlation for 5 Years ended March 31, 2018
- Correlation for 7 Years ended March 31, 2018

	MSCI China A	MSCI China Free	MSCI World ex USA	MSCI ACWI	MSCI Europe ex UK	MSCI Japan	MSCI Emerging Markets	MSCI Frontier Markets	Russell 3000	S&P 500
MSCI China A	1.00	0.67	0.34	0.36	0.27	0.46	0.35	0.01	0.32	0.31
MSCI China Free	0.70	1.00	0.83	0.81	0.78	0.65	0.88	0.54	0.66	0.63
MSCI World ex USA	0.30	0.79	1.00	0.96	0.97	0.73	0.90	0.75	0.83	0.80
MSCI ACWI	0.40	0.81	0.95	1.00	0.91	0.69	0.89	0.72	0.94	0.93
MSCI Europe ex UK	0.18	0.66	0.94	0.84	1.00	0.63	0.84	0.71	0.77	0.74
MSCI Japan	0.47	0.75	0.78	0.76	0.63	1.00	0.61	0.57	0.58	0.56
MSCI Emerging Markets	0.31	0.84	0.82	0.84	0.67	0.62	1.00	0.73	0.73	0.72
MSCI Frontier Markets	-0.13	0.45	0.66	0.65	0.61	0.44	0.68	1.00	0.58	0.58
Russell 3000	0.46	0.65	0.76	0.90	0.65	0.62	0.61	0.46	1.00	1.00
S&P 500	0.44	0.60	0.71	0.87	0.58	0.59	0.58	0.46	0.99	1.00

Sources: Callan, FTSE Russell, MSCI

China A is a fertile ground to generate excess returns given the high volatility of the asset class; it has been a source of value added for many investors.

Foreign investors can access the A-shares market in three ways:

- 1. Qualified Foreign Institutional Investor (QFII) scheme:** Launched in November 2002, the QFII scheme gives foreign investors access to all stocks listed on the onshore stock exchanges. Under this program, investors are able to use open-end funds and exchange-traded funds and engage in primary market activities such as an initial public offering (IPO). They may also invest in exchange-traded derivatives such as index futures. However, overseas institutional investors must be approved by the China Securities Regulatory Commission (CSRC). Following the approval, they can obtain investment quotas from the State Administration of Foreign Exchange (SAFE). There are capital mobility restrictions under this scheme—the maximum monthly repatriation is limited to 20% of the previous year's ending net asset value and exercisable only after a three-month lock-up period.
- 2. Renminbi Qualified Foreign Institutional Investor (RQFII) scheme:** The RQFII scheme allows subsidiaries of Chinese fund management companies and financial institutions registered in relevant jurisdictions to invest in the onshore securities market. It was launched in December 2011 and has gone through a few phases to improve the investment quota and expand the number of relevant jurisdictions. Following approval by the CSRC, foreign investors must obtain investment quotas from SAFE. The available instruments are the same under both schemes (QFII and RQFII). However, there are no limits on capital mobility under the RQFII scheme.
- 3. Stock Connect Northbound program:** The Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect programs allow foreign investors to bypass the eligibility and approval requirements of QFII/RQFII. While there is no capital mobility restriction under this program, the investment universe is limited. Further, investors are subject to a daily quota of Rmb 13 billion (USD 1.9 billion).

Measure twice, cut once

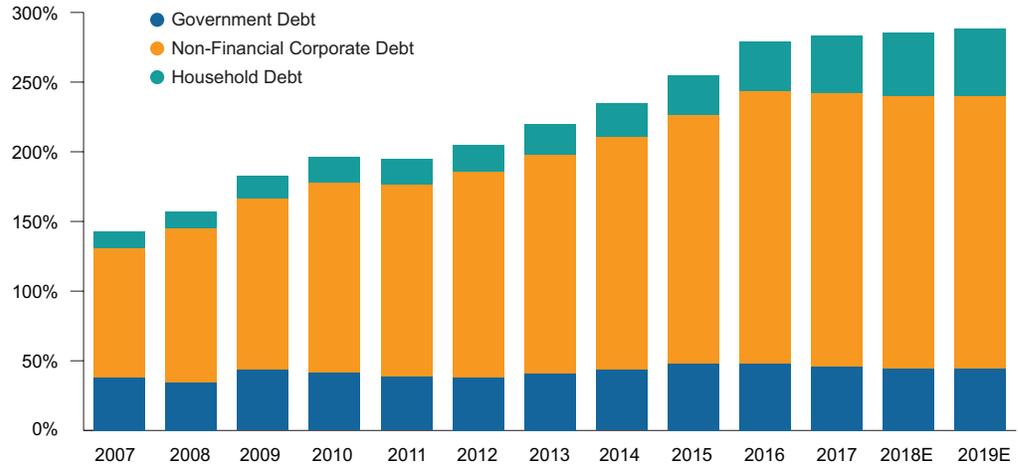
The further opening of the China A-shares market, via the Stock Connect programs, is a welcome sign for many global investors. With the inclusion of China A-shares, investors can access a much larger opportunity set of companies that are poised to benefit from a growing Chinese middle class. However, investing in China also presents a different set of challenges that should be carefully measured (if possible) and understood. Risks range from China's slowing GDP growth to the uncertain implications of one-party rule to stock trading suspensions.

China's GDP growth rate is no longer in the double digits as it was for many years up to 2010; the economy grew 6.9% in 2017. But it is expected to continue growing at a higher pace than developed countries and other economic regions of the world.¹¹ However, leverage in the Chinese economy has increased significantly in the last decade, raising concerns about a potential hard landing or financial crash (**Exhibit 4**). Corporate debt has been the biggest contributor to this growth as it surpassed 196% of GDP at the end of 2017. It is concentrated in China's SOEs that operate in the old-economy sectors such as heavy industry and real estate.

¹¹ World Bank Group. Global Economic Prospects, January 2018, "Broad-Based Upturn, but for How Long?"

Exhibit 4

China's Debt Breakdown as a Share of GDP



Sources: CEIC, Wind, Morgan Stanley Research, UBS

The A-shares market is known for its high number of trading suspensions. Trading in stocks can be suspended for a long period of time (in some cases, months). This can pose significant investability and liquidity issues for investors, especially during bear cycles, if they cannot exit positions. More than half of the 3,000 listed stocks were suspended from trading in 2015 due to extreme market volatility.

The onshore market is also characterized by its large retail investor base, which may have increased market volatility and pricing inefficiency. Retail investors, chasing after themes of the day and often driven by less-regulated “pump-and-dump” type schemes, can drive trading volume—they tend to trade rather than invest.¹²

Another concern for many investors is the large number of SOEs in the China A-shares market. They are prevalent in sectors such as energy and finance because of their strategic importance to the Chinese government. An increasing number of SOEs have faced challenges because of poor management, misaligned incentives, and high leverage. They also tend to be less liquid due to limited float. In general, they tend to be less profitable than privately owned companies.

¹²Neuberger Berman. *China: The Anatomy of An Equity Market*, 2018

Conclusion

China, already an important player in the global economy, is seeking to expand its influence through initiatives such as OBOR and diversify its economy by focusing on consumption and innovation. At the same time, the government is gradually opening up its capital markets to foreign institutional investors, giving them access to the world's second-largest equity market with many companies positioned to benefit from a burgeoning Chinese middle class.

China A-shares are ownership stakes in Chinese companies that trade on the Shanghai and Shenzhen stock exchanges and are quoted in renminbi. An allocation to A-shares could provide benefits in the form of competitive long-term returns and low correlation to other equity markets. But implementation is challenged by a shallow manager universe. Strategies dedicated to A-shares also command high fees, especially for investors seeking commingled products. Fees for pooled vehicles typically range between 150 and 200 basis points.

There are approximately 50 China A-shares products, according to eVestment, one-third of which are managed by onshore non-SEC registered asset managers. For some institutional U.S. investors, a requirement for SEC registration is not negotiable.

Despite these hurdles, investing in China A-shares is fertile ground for active management to potentially generate uncorrelated positive excess returns given the market's investment opportunities and volatility. Additionally, active managers are expected to benefit from the institutionalization of A-shares as China continues to open the market to foreign investors, ultimately shifting the composition of the investor base from retail to institutional.

With the addition of China A-shares in the MSCI Emerging Markets Index, global investors may no longer be able to ignore the significance of this growing market.

About the Author



Rufash Lama is an analyst in Callan's Global Manager Research group. His role includes the quantitative and qualitative analysis of investment managers and the compilation of detailed research reports for clients and the Manager Search Committee. Prior to joining Callan in June of 2015, he held internships at Dodge & Cox and Loomis, Sayles & Company.

If you have any questions or comments, please email institute@callan.com.

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San Francisco, CA 94111
800.227.3288
415.974.5060

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