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Investment perspectives

China and investing in emerging markets

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Is China still an attractive opportunity for investors?

In the face of rising geopolitical risks, government regulatory interventions and the ever-growing importance of Environmental, Social and Governance (ESG) factors, this article discusses the opportunity and challenges of investing in Chinese equities.

The Chinese economy has experienced significant structural changes and capital market reforms. This is likely to continue and could lead to better risk-adjusted returns for Chinese equities. However, there is a lot of variability around these long-term expectations. This includes geopolitical risks, the pace of structural reforms, Chinese government policies to rebalance inequality in its economy, corporate governance, market liquidity and other ESG factors.

The opportunity

Chinese equities are growing and their weight in emerging markets and global indices is increasing, which cannot be ignored. However, many investors are underinvested. For many, exposure to China is primarily through offshore listed equities. This approach could potentially limit the ability to benefit from the future evolution of the Chinese economy, which will be increasingly reflected in its onshore equity market, China A-shares[1]. This part of the market captures many of the secular growth trends of China's economy, thus offering further diversification benefits. Below, we consider the opportunity from a sectoral perspective and highlight the dominance and growing size of the Chinese equity market in global indices.

The growing dominance of China's weight in the global indices

China accounts for around 34% of the Morgan Stanley Capital International (MSCI) Emerging Market Index, while the weight of onshore Chinese equities (China A-shares) is only about 5%. However, its onshore equity market is large and although it continues to be dominated by local and retail investors, as liquidity and access to foreign investors improve, the Chinese equity weight in global indices will likely increase.

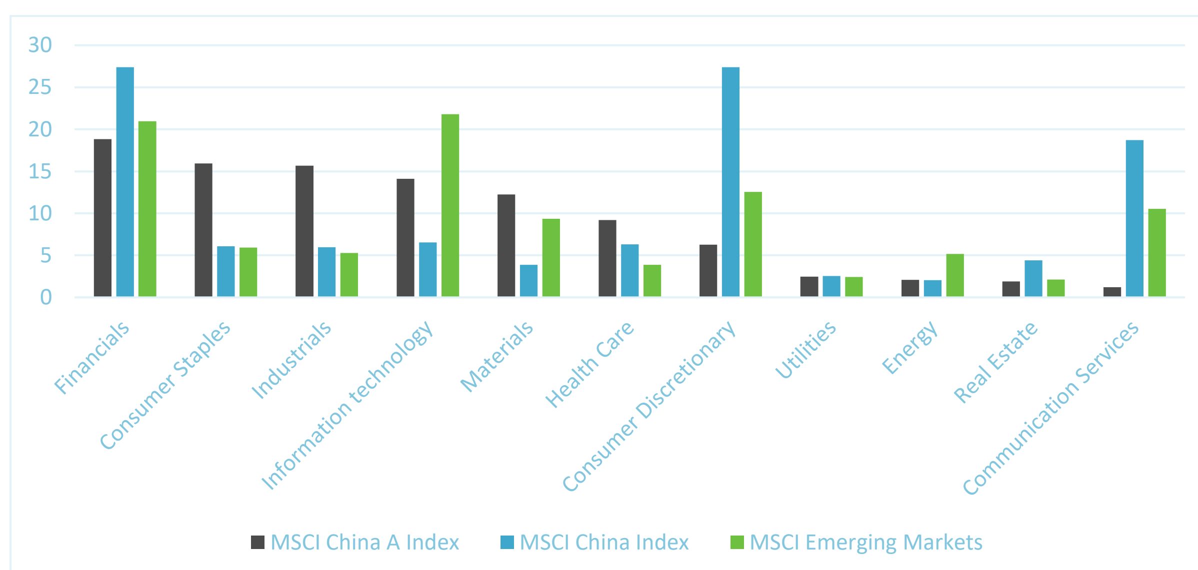
The composition of the China-A index offers more diversification

The MSCI China index is highly concentrated in certain stocks. For example, Tencent and Alibaba combined represent around 30% of the index while the top 10 stocks represent around 40% of the index. Consequently, the performance of the indices has been driven by a small group of companies. On the other hand, the onshore index (MSCI China A Onshore) is more diversified and the opportunity set is broader, both in terms of the number of stocks and market capitalisation. The MSCI China A-shares index includes around 500 stocks, including many mid-cap and small companies, and the performance drivers are wider.

[1] A-shares are domestic Chinese company stocks listed onshore in Shenzen or Shanghai.

There are also sectoral differences with the MSCI China index, which is skewed towards communication services, consumer discretionary and financials. The China A-shares index has higher allocations to information technology, consumer staples and healthcare, providing more exposure to a more consumption-oriented and innovation-led economy.

Chart 1: Sectoral differences – MSCI China A, MSCI China and MSCI Emerging Markets



Source: MSCI Emerging markets index as at Feb 2022.

Currently, the China A-shares domestic market is dominated by local retail investors compared with other emerging and developed equity markets. This makes the Chinese domestic listed equity market more inefficient and provides more opportunities for generating alpha through stock selection. That said, the China A-share equity market is highly volatile, but as access for foreign institutional investors improves and liquidity increases, this volatility should become more in line with the rest of the emerging and developed equity markets.

The challenges

Geopolitical risks remain, and these have intensified during the Russia-Ukraine war. This has led to some investors becoming more concerned about a similar situation arising with China and the likely sanctions and implications of such a scenario. However, although this is difficult to predict, China has established itself as one of the largest trade partners for most of the economies in the world and is highly integrated into the global supply chain. This can be viewed as a positive and sufficient to prevent any conflict. Another geopolitical risk is US-China relations. This is still a risk that continues to be real, although the issues are more centred on economic and technological superiority.

China, as with many other emerging market countries, lags developed markets on ESG standards and disclosures. The integration of ESG in investment decision-making also starts from a low basis, especially for the local asset managers. On the other hand, the Chinese government has emphasised environmental and social responsibility as part of its five-year plan. Despite these being positive steps towards sustainable investing, some of the ways in which the Chinese government can be influential is by directly intervening through regulation in public listed equities. We have seen this more recently with companies in social media and education platforms (for example Alibaba, Tencent and New Oriental), which led to their stock prices falling significantly. These regulatory interventions can have a material adverse impact on the long-term fundamental and business case for some of these companies, but they can also open up opportunities for long-term investors.

Given the complexity of these issues and associated risks, it is sensible to gain exposure to China through active managers who can distil and select the best set of listed equity opportunities from a risk-reward perspective, applying both bottom-up and top-down analysis to help navigate this market.

Summary

We believe China is an attractive opportunity for long-term investors for the following reasons:

- The expansion of stocks in indices will provide more diversification and represent companies that benefit from the future growth of the Chinese economy
- These companies support long-term structural growth characteristics such as innovation, technology, consumer growth and healthcare
- The market is expected to become more institutional over time with improved liquidity and volatility.

However, there are many factors and risks to consider when investing in China such as geopolitical, government intervention and wider environmental, social and governance risks. Given all these complexities, our preferred approach for allocation to emerging market equities is through an active manager. There are many global asset managers with on-the ground resources in China, as well as local asset managers with dedicated expertise in this market.

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