Rocaton

INSIGHTS

An Exploration of China A-Shares

June 2017

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EXECUTIVE SUMMARY

- Given Rocaton's support of emerging market equities as a component of many investment programs, coupled with China's increasing importance in the global investment landscape, Rocaton believes it makes sense to study the China A-share market in more detail.
- To date, institutional investors have been able to access only part of the Chinese market through "H-shares", mainland companies that are traded in Hong Kong. China A-shares, local-currency shares traded on the domestic exchanges in China, are not included in the MSCI EM Index and are largely restricted from foreign institutional investment. If A-shares are opened to foreign capital, the investable Chinese equity market will be significantly larger than it is today.
- The case for A-share investment is predicated on the potential for these A-share companies to provide global investors a more direct way of monetizing the purported growth of the Chinese consumer. A-shares may also be appealing from a portfolio diversification and correlation perspective.
- Investing in China A-shares is not without risk. Industry participants remain concerned about sovereign risk as well as limitations on liquidity, beneficial ownership, and other issues.
- We expect that the MSCI EM Index will eventually expand the opportunity set and include A-shares, perhaps as early as June 2017. However, the immediate portfolio impact to clients should be gradual. Over time, as the weight to A-share companies in portfolios or the index grows, clients will want to consider other elements such as volatility, overall portfolio structure, and fees.
- Rocaton's survey of the largest EM managers indicates that many firms are already making modest investments in A-shares. Those firms not currently invested in A-shares are actively contemplating and researching A-share opportunities.
- *We do not seek to opine on the relative attractiveness of China vis-à-vis other countries or in absolute terms. However, in recognition of capturing the most robust alpha opportunity set within emerging markets, Rocaton supports the consideration of A-shares as a potential source of return for client portfolios with an appropriately long time horizon and level of risk tolerance.*

Introduction

According to the IMF, recent data suggests that China now accounts for 17% of the world's GDP, a number that has steadily increased in recent decades[1]. Despite its importance as a driver of global growth, global investment portfolios do not commensurately allocate to China in part due to the many restrictions placed on foreign investment in A-shares by the Chinese government. However, over time, we expect the China weight in EM equity portfolios to steadily increase and more fully reflect the importance of China as a driver of global growth, especially as the Chinese government continues to open its investment borders to foreign capital. The likelihood for eventual inclusion of A-share companies in the MSCI EM Index may therefore serve as a bellwether for the industry to begin more seriously considering investment. This paper explores the rationale for; the accessibility of; and the risks of investment in China A-share companies. While we do not offer an opinion on the absolute or relative attractiveness of China as a country, here as elsewhere we do encourage the most robust alpha opportunity set in equities for active investment managers. Predicated on our philosophy that investment in emerging markets should be undertaken with an appropriately long time horizon and tolerance for volatility, we suggest that the potential alpha generation opportunities provided by these domestic Chinese companies should not be ignored by investors in EM equities. Rocaton's view is that EM managers should fully consider the A-share opportunity set for client portfolios.

[1] Adjusted for purchasing power parity. Source: International Monetary Fund, 2015 data released June 30, 2016.

What are China A-shares?

The Chinese equity market, now the world's second largest[2], is comprised of onshore, domestically-traded A-shares and offshore H-shares. On the onshore side, China A-shares are shares of companies incorporated in mainland China traded on either the Shenzen or Shanghai Stock Exchanges, the two domestic China exchanges established in 1990[3]. A-shares are traded and settled in renminbi, and have historically been traded only by domestic Chinese investors. As they are not listed on international exchanges, it has been difficult for foreign investors to invest in these mainland companies.

In 1993, Chinese companies, including state-owned enterprises (SOEs), were permitted by the Chinese government to list shares on the Hong Kong Stock Exchange[4] in a slow but gradual opening of the markets to foreign capital[5]. As a result, when a Chinese mainland company lists shares on the Hong Kong Stock Exchange, they are known as "H"-shares. Today, many Chinese mainland companies are dual-listed on mainland Chinese exchanges as well as in Hong Kong. Over 80% of China's listed companies trade in either Shanghai or Shenzen, and Rocaton notes that the size of the A-share market, by number of companies as well as market capitalization, far outweighs the size of the H-share market[6].

Figure 1:

Number of A-share versus H-share companies

	China H-Share Market		China A-Share Market	
Year	Number of Listed Companies	Market Cap ($millions)	Number of Listed Companies	Market Cap ($millions)
2000	50	11,042	855	477,169
2001	58	13,038	924	438,113
2002	74	16,917	987	384,830
2003	92	52,610	1,058	445,138
2004	109	59,489	1,155	393,210
2005	120	116,001	1,158	355,765
2006	141	433,793	1,230	1,070,030
2007	146	651,992	1,394	4,311,315
2008	150	352,735	1,544	1,734,533
2009	156	607,950	1,654	3,540,446
2010	162	672,379	2,041	4,005,318
2011	168	528,506	2,320	3,391,012
2012	174	629,793	2,472	3,672,039
2013	182	633,958	2,468	3,928,489
2014	198	727,606	2,580	5,966,369
2015	226	665,888	2,850	8,171,049
2016	239	686,886	3,032	7,295,253

Source: FTSE Russell, Bloomberg. Data as of March 31, 2017.

Accessing A-shares

As part of Chinese regulators' continued push for market liberalization, foreign access to A-shares has become more available in the last 15 years, though the scope has been limited. Investors authorized as Qualified Foreign Institutional Investors ("QFIIs") and Renminbi QFIIs ("rQFIIs") have been granted access to A-shares via a quota system starting in 2002 and 2011, respectively[7]. By restricting access through quotas, Chinese officials have been able to regulate foreign investment and limit potentially outsized outflows during market downturns. However, market participants have bemoaned the level of capital controls exercised by the Chinese government. For example, in January 2016, the government implemented a circuit-breaker mechanism that suspended market trading for 15 minutes when stocks fell by 5%, and halted trading for the day when stocks fell 7%[8]. New policies implemented by the local exchanges have since brought the number of trading suspensions back to historical levels. However, per MSCI, the number of

[2] As of 2016, the market capitalization of listed companies in China comprises ≈11.5% of global equities, in USD. This combines A-shares as well as stocks traded on the Hong Kong Stock Exchange. Source: World Federation of Exchanges database, The World Bank. [3,5,8]CSRC, People's Rebulic of China. [4]Hong Kong Stock Exchange. [6]Bloomberg. [7]Ibid

trading suspensions in the A-share market is still the highest globally. Additionally, there have been a number of structural issues for foreign investors with the quota scheme - a lengthy application process, operational and eligibility challenges, limits on permitted investments, broker-dealer restrictions, concerns over beneficial ownership, and worries about the country's relatively opaque framework that governs investment. Some of the QFII program rules have been modified in the last five years to address these problems but overall, total quota available via QFII and RQFII amounts to only ≈2% of China's total market capitalization[9].

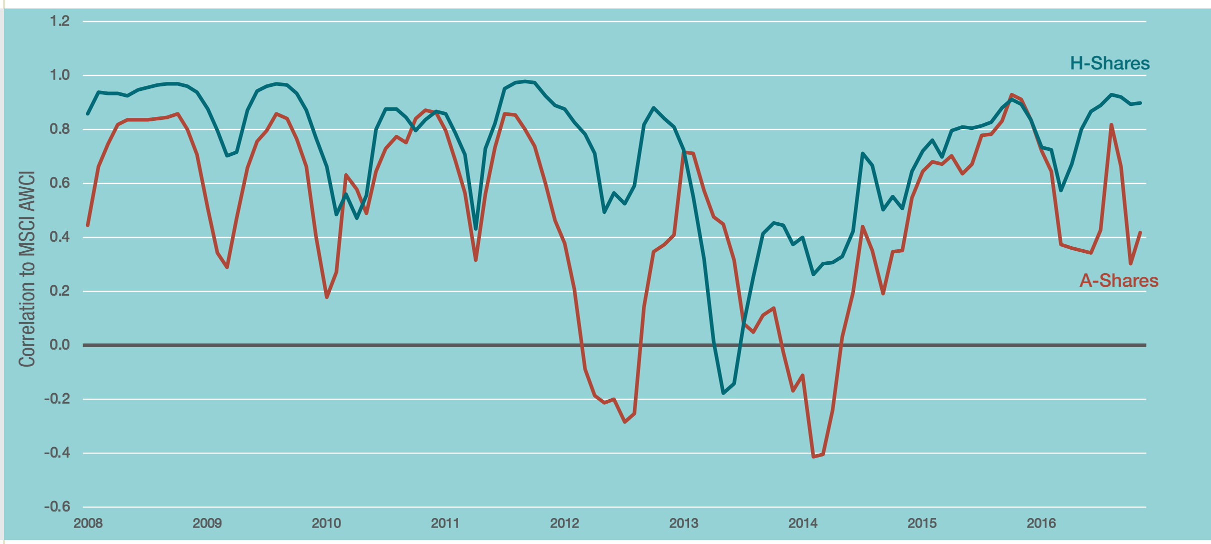
To further open the Chinese A-share market to foreign investment, China also launched the Shanghai-Hong Kong Stock Connect in 2014, which helped increase A-share accessibility. In December 2016, in perhaps a much more seminal move, officials also launched the Shenzen-Hong Kong Stock Connect. By not forcing investors to register onshore, the Stock Connect links allow foreign investment in A-shares in a less restrictive manner than previously offered.

The A-Share Opportunity Set

The attractiveness of investing in A-shares today is fairly straightforward – they provide global investors a more direct way of being able to participate in the purported growth of the Chinese consumer in a more efficient and less restrictive manner than historically has been the case. Via A-shares, the opportunity set to invest in the Chinese growth is wider (there are over 3000 listed A-share companies), there is added potential for portfolio diversification, and investors would have the ability to own stocks that are unavailable in Hong Kong and are thinly followed. However, the relative attractiveness of A-shares versus H-shares is also partly based on the characteristics of H-shares themselves.

Figure 2:

A-shares and H-shares versus MSCI ACWI - Rolling 1-Year Correlation



Source: FactSet. Based on data from June 2008 through April 2017

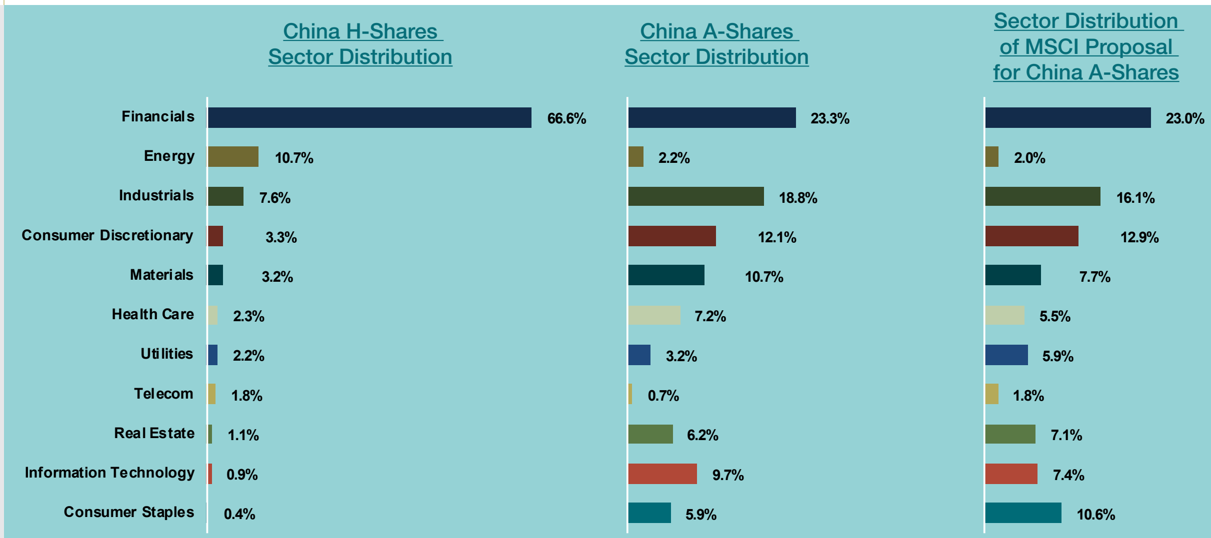
First, as a more "mature" market that has been open to foreign investment for nearly thirty years, H-shares are more institutionally owned and therefore arguably more correlated with developed markets, as demonstrated by the chart above. Institutional investors account for 65% of total turnover on the Hong Kong exchange[10]. Foreign ownership of listed Korean equities amounts to ≈30% versus 30% in Brazil, and ≈20% in Russia[11]. By contrast, in 2016, foreign ownership amounted to less than 1.2% of Shenzen-listed A-shares and less than 1.5% of total listed A-shares[12].

[9]Shanghai Stock Exchange and Shenzen Stock Exchange, as of March 2016. [10,12]Hong Kong Exchange. [11]Bloomberg, Credit Suisse

The sector makeup of H-shares is also narrow. H-shares are primarily comprised of companies in the financials, materials, and industrials sectors[13], which often indicates a heavier level of state ownership, increased leverage via the Chinese banking sector, and lower exposure to Chinese consumer growth. Conversely, the broader cross-section of A-share companies falls into more consumer-oriented sectors such as technology, healthcare, and consumer cyclicals. The opening of the Shenzen Stock Connect link may be particularly appealing from an investment perspective. Over 50% of companies listed in Shenzen can be characterized as "New China" companies exposed to consumer growth, with fewer large caps. And, whereas 70% of companies listed in Shanghai are SOEs, over 75% of Shenzen stocks are privately owned[14].

Figure 3:

Sector Distribution



Source: MSCI

Investors may also be attracted by a temporary arbitrage opportunity for dual-listed companies. A-shares have generally traded at a valuation premium given the restriction on foreign investment, resulting in a significant price discrepancy between H-shares and their A-share counterparts. We expect that any gap in price between A-shares and H-shares will narrow as onshore companies are opened to foreign capital and H-shares re-rate.

Risks of A-share investment

Investment in A-shares, despite exposure to China's burgeoning consumer-driven economy, is not without risk. As with any country, there is the potential for significant sovereign risk especially if central government rules change. There are also structural challenges with the existing mode of accessing A-shares, such as through the QFII/RQ-FII quota scheme. A number of global investors have material concerns over issues such as beneficial ownership, trading suspensions of domestic stocks, and limits to monthly repatriation. Any potential liquidity constraints or restriction on repatriation of assets may be especially critical for registered US funds, which are daily valued with daily liquidity. By regulation, such funds cannot allocate more than 15% of net asset value to illiquid investments[15].

As researchers evaluate individual mainland companies for investment, there may be a level of opacity at the corporate governance level which could be difficult to surmount.

[13]Sometimes characterized as the sectors of "Old China". Historically a large number of SOEs were listed in Shanghai versus Shenzen. [14]Bloomberg.
[15] SEC Document – "Final Rule, Investment Company Liquidity Risk."

In 2011, the China Securities Regulatory Commission ("CSRC") conducted an evaluation of domestic corporate governance standards and acknowledged the potential conflict of interest between minority and majority shareholders, in light of concentrated ownership in the hands of the state or another controlling interest[16]. Additional progress is also likely needed in areas such as board composition, disclosure of related party transactions, reporting and veracity of data, and the overall effective implementation and enforcement of Chinese corporate law.

These may be issues of significant concern from an investment standpoint, which managers must consider and which ultimately may preclude widespread allocation to China A-shares.

MSCI and China A-share Inclusion

Since 2014, MSCI has considered the topic of A-shares annually, but has been unable to approve inclusion in the EM index. As a result, the current 27% benchmark exposure to China is comprised of H-shares, which as previously discussed, limits the sector diversification of the Index[17]. Several other index providers have already included A-shares in their index suites. FTSE Russell announced the creation of a new A-share -inclusive EM benchmark in 2015, and Bloomberg also included A-shares in a bond index in early 2016. However, as an estimated $1.5 trillion in assets tracks the MSCI EM benchmark[18], we have therefore looked to MSCI as the standard-bearer for global institutional A-share inclusion.

In June 2016, MSCI cited three remaining obstacles relating to general market accessibility including 1) effective implementation of recent QFII policy changes and removal of monthly repatriation limits, 2) effective implementation of new trading suspension rules, and 3) resolution of local exchange pre-approval requirements on launching financial products[18]. Chinese officials have taken some steps in the intervening year to address concerns on A-share investability, including launching the Shenzen Stock Connect and lowering voluntary trading suspensions to historical levels. However, there are some open items that have yet to be resolved and the key hurdle today appears to be the insistence by Chinese regulators on a pre-approval path for financial products linked to indexes with A-shares.

In March 2017, MSCI issued a new consultation paper to equity market participants on the potential inclusion of China A-shares. The new proposal appears to adopt a conservative, more measured pace to inclusion than past iterations, presumably in recognition of the widespread industry concerns. Historically, MSCI contemplated A-share investment in a universe of large, mid, and small capitalization stocks with access through QFII/RQFII quotas. Instead, MSCI is now considering investment in a narrow subset of large cap A-shares through the Shanghai/Shenzhen Stock Connect links. Large cap companies are likely to provide greater liquidity, which will be of some comfort to investors, and the "Connect" access framework ameliorates some of the QFII/RQFII issues. The new proposal also eliminates securities that have been suspended from trading for more than 50 days in the past 12 months and suggests the use of offshore rates for index calculation instead of onshore rates. Finally, dual-listed companies and IPOs would also be excluded from benchmark inclusion.

[16]CSRC, People's Republic of China. [17]MSCI. [18]Ibid.

Potential Impact of A-share Inclusion

As clients consider how A-share inclusion in passive and active EM strategies could potentially impact their investments, we would note that the immediate impact should be fairly muted. First, there will likely be a reasonable lag between the time of the announcement and the actual launch of the modified benchmark. Second, the pace of A-share inclusion will be gradual. If MSCI's latest proposal is enacted, the addition of 169 large cap A-shares would amount to 0.5% of the total EM index at an inclusion factor of 5%[19]. There is precedent for a gradual pace of inclusion, though Rocaton notes that the proposed A-share inclusion factor for Chinese onshore names is inordinately low compared with prior new entrants. For example, Taiwan and Korea, now both EM constituent countries, took lengthy periods before inclusion factor caps were lifted completely. Taiwan was first included in the MSCI EM Index in 1996 with a 50% inclusion factor - it was 2005 before Taiwan was 100% included. Korea was first included in 1992 with a 20% factor, then was raised to 50% in 1996 and fully included in 1998[20]. It is worth acknowledging that at the full inclusion factor and absent any other significant changes in country weights, A-shares may comprise as much as 18% of the pro-forma benchmark weight at a full inclusion factor[21]. As a result, the total China weight including A-shares potentially could exceed as much as 40% of the MSCI EM Index[22]. To reiterate, full inclusion is not expected in the near to medium term. However, over longer time periods, as the market more fully reflects China's contribution to global GDP and given the potential size of China in the overall benchmark, it is possible that global portfolios may evolve to include a more structural allocation to China, not dissimilar to how global portfolios allocate to the United States.

On the passive side, the inclusion of A-shares will automatically trigger flows into companies added to the benchmark, which may result in elevated valuations and additional price volatility. For active EM strategies, we expect that the addition of A-shares to the index (and expansion in the A-share weight over time) will result in higher tracking error if managers either choose not to invest in A-shares or if they invest in off-index names, especially in smaller capitalization companies.

Over time, we expect that A-share inclusion will introduce an added level of volatility within the EM Index and in client portfolios containing A-shares. China A-shares have historically exhibited a fairly volatile trading pattern where double-digit percent intraday swings are not uncommon[23]. A recent index provider survey estimated that 80-90% of China A-shares trades are executed by retail investors where 73% of the 200 million domestic retail accounts trade at least monthly[24]. In the long run, the introduction of global institutional investors to the A-share market may provide a more stable and rational mechanism for price discovery of onshore Chinese shares.

Outside of a change in the actual index weight to China, the sheer number of stocks that will eventually come into the EM investment universe may be a resource or systems headwind for active managers. There are ≈150 stocks in MSCI China and 822 total stocks in MSCI EM currently, but over 3000 listed onshore Chinese companies not yet included[25].

[19]Like most index providers, MSCI evaluates free-float market capitalization at the individual security level to define weights of stocks within its benchmarks. However, to finally determine the investability of a company, MSCI applies a special adjustment called the "foreign inclusion factor", meaning that it considers the headroom available for new foreign investors to invest in the stock. The proportion accounts for the available free float of and/or the foreign ownership limits applicable to a specific security or company. In the case of A-shares, the inclusion factor is applied to the free-float adjusted market cap of China A-share constituents in the pro-forma MSCI China Index. China A-share securities are subject to a foreign ownership limit of 30%. [20]MSCI. [21,22]Ibid. [23]Bloomberg. [24]SSgA Survey. [25]MSCI, Bloomberg.

This represents an eventual challenge in research coverage for asset managers without significant local investment expertise or prior history of A-share evaluation or investment. As managers increase the number of dedicated resources and local investment expertise, strategies with A-share allocations could have slightly higher fees. As previously discussed, asset managers may also have difficulty in finding A-share companies that meet their criteria for investment if A-share valuations appear overextended, data transparency is poor, or western corporate governance standards are not adopted by local companies. However, the measured pace of adoption will undoubtedly mitigate these issues by allowing managers lead time to grapple with the expanded investment universe, and onshore companies time to interface with foreign investors and become more institutionally friendly.

Clients invested in active EM strategies via separate accounts also should be prepared to modify investment guidelines as managers gradually include A-shares in portfolios. If opting out, clients should be aware of potential performance differences that may arise in their account vis-à-vis strategy composites. Depending on the size of A-shares in the benchmark and the portfolio, these differences could be significant. Finally, we note that clients invested in EM mutual funds should be especially mindful of the previously described liquidity challenges and restriction of A-share investment.

How asset managers are invested in A-shares today

Rocaton surveyed the top 25 EM equity investment managers by assets (as listed by eVestment Alliance as of March 2017) to help frame how global EM portfolios are positioned today. The key takeaway from our survey is that the majority of larger EM equity firms are already invested in A-shares (many in their dedicated global EM portfolios), and even those that aren't currently invested are actively engaged in researching A-share companies.

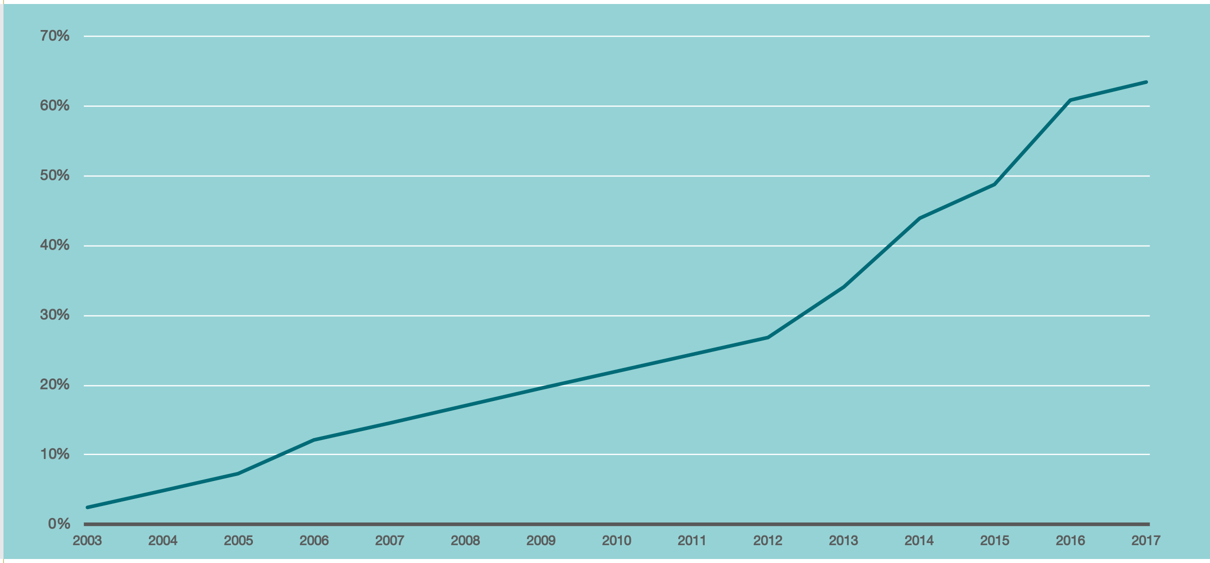
In perhaps the most interesting statistic, 76% of respondent managers are registered to invest in A-shares and 71% are currently invested in A-shares. Nearly half maintain A-share investment specifically in their EM portfolios. As demonstrated by the chart below, the number of Top 25 managers (by assets) invested in A-shares has increased meaningfully in recent years. A significant percentage of respondents confirmed significant in-house resources directed to A-share evaluation, with the majority of managers currently invested in A-shares accessing investment through multiple channels including QFII/RQFII as well as Stock Connect. 25% of managers currently invested in A-shares limit their access solely through Stock Connect.

For the firms that are invested in A-shares, survey responses indicate that a large majority (over 70% in most cases) of their invested clients have supported A-share investments. 60% of managers with A-share investments, however, did not need to alter client guidelines to invest in A-share companies. Managers indicated that overall portfolio characteristics did not change with the inclusion of the A-shares, likely because the total portfolio allocation to A-share companies has been appropriately risk-adjusted. Several managers suggested slight increases in tracking error ranges of the portfolios, which is consistent with the effects of most off-benchmark exposures.

Of the 28% of survey respondents that are not invested in A-shares, all of them cited concerns regarding liquidity (mainly profit repatriation and trading suspensions), a lack of transparency into fundamentals, and fewer companies that meet the high hurdle of investment criteria. These managers largely indicated these issues require resolution before they would contemplate A-share investment, but some stated they would re-evaluate A-share investment if the benchmark included A-share companies. Notably, several managers stated that investment conditions in China were improving. Perhaps most importantly, all of the managers not currently invested in A-shares still continue to actively research the space.

Figure 4:

% of Managers Investing in A-shares



Source: Rocaton

Rocaton's View on A-share investment

As a reminder to clients, Rocaton's philosophy on investment in emerging markets is predicated on an appropriately long time horizon and tolerance for volatility in the asset class. In that spirit, we encourage clients and asset managers alike to continue to prepare for the increasing importance of A-share companies in the global equity markets. Rocaton's view is that investment in A-share companies should be treated no differently than investment in any other company and whether A-shares are included in portfolios should be at the discretion of the active manager. As with any prospective holding, evaluation of A-shares should occur in accordance with the firm's investment philosophy. If onshore companies meet the investment criteria at a given manager and are deemed to be attractive investments, they should be considered for portfolio inclusion regardless of benchmark inclusion. Given the risks cited above, the manner of investment in A-shares should certainly be thoughtful. Investment teams should deploy enough resources to be able to appropriately assess the risks of potentially investable A-share companies including any sovereign or liquidity risk associated with holding the position. Investment in A-shares may prove to be an under-followed, long-term, differentiating and diversifying source of alpha in emerging market portfolios – Rocaton therefore remains supportive for managers to freely and fully investigate this potential source of return for client portfolios. Clients should continue to be very selective in choosing emerging markets managers, ensuring that they have the robust investment resources necessary to evaluate the broadest possible opportunity set in emerging markets, with a thorough understanding of the investment landscape and risks.

Conclusion

Going forward, Rocaton expects A-shares will be an area of increasing importance in global equity allocations as China continues to open its investment borders to foreign capital. The eventual inclusion of A-shares in the MSCI EM Index will likely serve as a bellwether for the industry to begin seriously considering investment in these companies. However, our survey of the top asset managers in the EM space has confirmed that many have already begun investing in A-shares. While the immediate effect on portfolios is expected to be negligible at the outset, over time, A-share inclusion will likely introduce an added level of volatility within the EM Index and in client portfolios. Predicated on Rocaton's philosophy that investment in emerging markets should be undertaken with an appropriately long time horizon and tolerance for volatility, Rocaton feels that the potential alpha generation opportunities provided by A-shares companies should not be ignored and that EM managers should fully consider the mainland China opportunity set for client portfolios as they would any other region. We maintain that selectivity and thoughtfulness is going to be of the utmost importance not only for clients who select EM managers, but for managers themselves who are deploying capital into onshore companies, in recognition of the many risks and concerns cited by market participants investing in China.

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