Reassessing Opportunities in China A-Shares

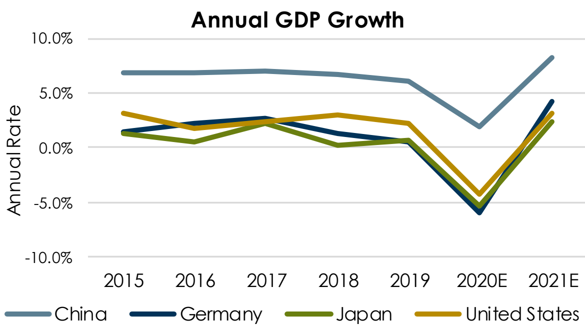
January 2021

OVERVIEW

- **In 2020, Chinese equities outperformed most global equity markets, particularly emerging markets**
- **China's domestic (A-share) equity market remains relatively untapped by foreign investors**
- **With US Large Cap equities dominating for the last decade, China's domestic equities may present opportunities going forward**

Background

Even prior to COVID-19, China's economy had been growing at a faster pace than the rest of the world. Following the pandemic-related disruption and a -10% Q1-20 GDP reading, China's economy is still expected to advance 1.8% for 2020, while the rest of the world posts a 4.4% decline. Looking ahead, the IMF forecasts that China could accelerate by over 8.0% in 2021. This is in contrast to more modest growth forecasts for large developed economies like the US (+3.1%), Germany (+4.2%), and Japan (+2.3%).



Source: IMF, WEO Database, October 2020, ACG Research

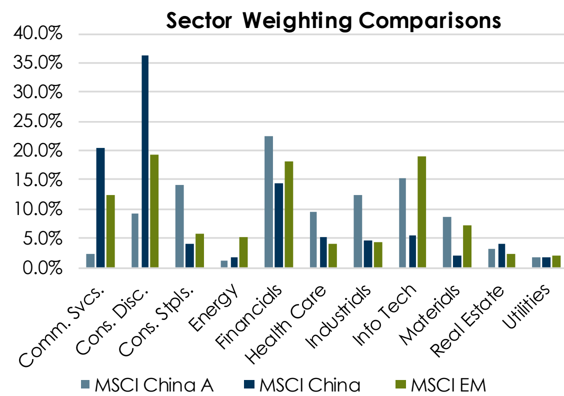
In 2020, China's equity market performance was a significant contributor to the overall performance of the MSCI EM index, but also compared favorably to US equities. For the calendar year, US Large Cap stocks (S&P 500) returned 18.4%, US Small Cap stocks (Russell 2000) returned 20.0%, and Emerging Market stocks returned 18.7%. However, within the MSCI EM index, China, representing about 40% of the EM index, was up 29.7%.

The Investment Case for China

China is the second largest economy and a significant contributor to global growth. China continues to transition from an economy driven by agriculture and manufacturing to a more domestic oriented, service and consumer driven economy. As China's middle class continues to expand so will the aggregate purchasing power of this group, supporting the economic transformation. There has also been a favorable trend in privatizations (IPOs), adding to the investable opportunity set.

Evolving Equity Market Composition

Access to Chinese equities is typically achieved through a global emerging market equity mandate, either an active or passive strategy, long-only or long/short. An active strategy allows the manager to increase or decrease regional/sector allocations based on the mandate. In the past, most China exposure was achieved via Hong Kong listed companies or entities listed in the US as ADRs. The move to allow foreign investors to access the Chinese onshore markets (China A Shares) has greatly expanded the opportunity set as this market includes approximately 3,900 companies with an aggregate market capitalization of just over $8 trillion, nearly equal to the market cap of the shares listed in Hong Kong and US listed ADRs. Many of the companies in the China A Shares index are currently not widely followed by global research firms (inefficient market), and the MSCI China A Onshore index possesses differentiated sector weightings vs. both the MSCI China and MSCI EM indexes.



Source: MSCI, ACG Research.

While China is Growing, it Remains Underrepresented

China represents about 16% of global GDP, and nearly 40% of global GDP growth. However, the China weight within the MSCI All Country World index (ACWI) is approximately 5%, while the US, currently 23% of global GDP, represents nearly 58% of the index. Within the Emerging Markets benchmark (MSCI EM index), China represents approximately 40%, and once "full inclusion" is achieved, (i.e., the liberalization of the China A shares market, including abolishment of the trade quota system, full liberalization of capital mobility, and an alignment with international accessibility standards), China could potentially represent in excess of 50% of the MSCI Emerging Markets (EM) index and approximately 7% of the MSCI All Country World (ACWI) index.

ACG's Position

As China continues to grow and open its markets to foreign investors, the opportunity set continues to expand and investors are seeing more managers launch China specific strategies. Despite the opportunities, investors should be aware of unique risks, including China reversing its support of private enterprise and wealth creation, along with global trade and political tensions (namely between China and the US) resulting in further retaliatory actions. ACG continues to evaluate opportunities to invest in China A-shares, acknowledging that suitability is dependent on each client's unique investment objectives.

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