“ In the year of the dog, is it time to bite? ”

Greg Kuhnert

Greg is the portfolio manager for the Asia ex Japan Equity and All China Equity strategies and co-portfolio manager for the Asia Pacific ex Japan Equity Strategy in the 4Factor™ team at Investec Asset Management.

2 The alpha and beta of Chinese equities

SUMMARY: From June 2018, MSCI will include 233 large-cap China A-shares in the MSCI Emerging Market and All-Country World indices. The initial impact on indices will likely be small due to MSCI’s phased approach to inclusion. However, we feel the effect could be more significant than investors realise. We believe savvy investors who introduce this early into their portfolios will be rewarded. They will be investing in an inefficiently priced asset class, where the long-term earnings growth outlook is superior to developed markets, thereby offering an attractive risk/return ratio or more ‘efficient frontier’ (i.e. achieves greater returns for a given level of risk).

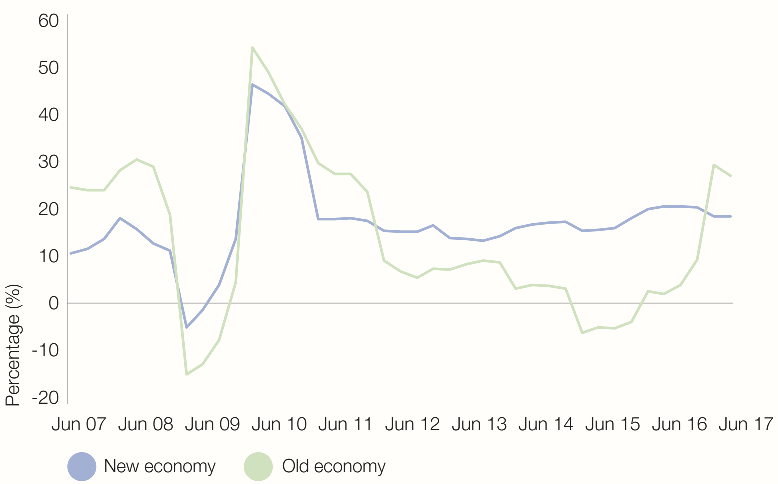
New economy, old economy: where's the growth?

We believe that Chinese equities currently offer superior long-term earnings growth potential. Moreover, they are currently trading at a discounted valuation to developed markets. Both 'old' and 'new' sectors of the economy offer idiosyncratic investment opportunities.

The 'new' economy sectors that are still lagging developed markets offer interesting opportunities. Sectors such as consumer, technology, internet and healthcare have experienced steady growth and progressively increasing returns. China has one of the highest global growth rates for e-commerce, technology, consumer discretionary and healthcare.

In the 'old' economy we see potential for improving profitability from industry consolidation, cost cutting and supply-side reform. 'Old' economy sectors, such as banks, real estate, commodities, heavy industrials and utilities, are recovering, while capital expenditure has not increased for several years. This means that the free-cash-flow-to-equity holding metric is improving, while leverage is falling, creating interesting investment opportunities. The old economy is also benefiting from a lower cost of borrowing as a result of government reforms.

Figure 1: 'New' economy revenue growth is strong. 'Old' economy improving A-share sales growth year to date, year on year.



Source: Wind, 30.06.17

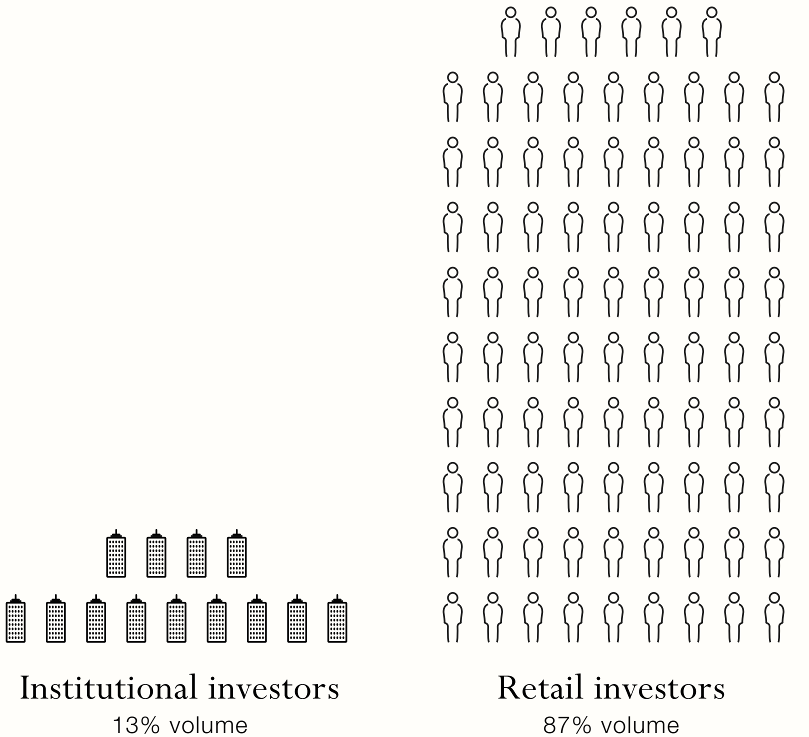
Inefficient markets ripe for picking

The inefficient Chinese A-share equity market often behaves erratically from an outside perspective, largely due to the dominance of retail investors, poor data quality and inefficient capital allocation. As a result, some investors believe that investing on the basis of corporate fundamentals and behavioural finance will not work in this market. Nothing could be further from the truth.

Our analysis has uncovered considerable divergence in valuations and share prices compared to developed markets. We find that the A-share market has the hallmarks of a market that is less efficient than developed markets, making it an ideal arena for rigorous, bottom-up stock selection.

Mom and pop run the show

Trading volume of institutional and retail investors in Chinese A-share market



Source: CICC, Shanghai Stock Exchange, June 2017.

Foreign institutional investors largely absent

The lack of foreign investor participation reflects the historic difficulty in accessing the onshore equity market. The virtual absence of foreign institutional investors means that the Chinese A-share market has largely danced to its own tune.

As China's domestic equity market opens up to foreign institutional investors and MSCI raises its inclusion factor for the A-share market, foreigners will become a larger participant in the A-share market. As a result, we expect correlations with other global equity markets to increase gradually. This leaves a window for savvy, patient investors to access the opportunity by building a position now while correlations remain low and valuations discounted relative to developed markets. We believe that the Chinese government is committed to further liberalising its markets over time.

The 'all-China' advantage

An all-China approach allows the manager to consider the entire universe of Chinese stocks. The MSCI China Index only includes 149 companies, whereas the MSCI All-China Index includes 1,023. If a manager wants to gain exposure to a particular sector or theme then it makes no sense to ignore certain companies because of where they are listed.

Nearly 100 companies have shares listed both onshore and offshore. On average, the onshore shares of these dual-listed stocks trade at a 28% premium to the offshore shares, although the range is very wide. The difference exists because the closed nature of the onshore market makes arbitrage between the two difficult. However, the Chinese government is improving access to both the onshore and offshore markets, e.g. through the Hong Kong Stock Connect programme. As a result, we believe these valuation discrepancies will be arbitraged away over time. Adopting a wider stock universe like 'all-China' allows investors to benefit from this offshore and onshore convergence.

Indebtedness risk persists

Despite all the positives, indebtedness remains a risk to the Chinese investment thesis. As the economy transitions from investment to consumption, we are seeing a rise in non-performing loans (NPL). China has been taking progressive measures to contain this risk through lowering interest rates, restructuring debt and increasing the transparency of the debt market. However, there is much to be done and this is the area where investors need to be wary and constantly assess their risk management processes. We advocate avoiding those companies with high gearing and large amounts of dollar-denominated debt, in preference for those with improving or clean balance sheets, and diversified sales regions.

Conclusion: a compelling investment thesis

We believe Chinese equities offer compelling opportunities for investing in companies operating in both the 'new' and 'old' economy. Including A-shares in portfolios offers additional exciting opportunities to disciplined bottom-up stock pickers, with the dominance of retail investors creating many inefficiencies for active managers to exploit. It should also allow for more efficient portfolio construction, given the lower correlations of A-shares to global equity markets. This opportunity, in our opinion, is best exploited using an 'all-China' approach, since this gives investors the widest possible access to companies that stand to benefit from China's evolving growth dynamic.