Investments

The merits of a standalone equity allocation to China

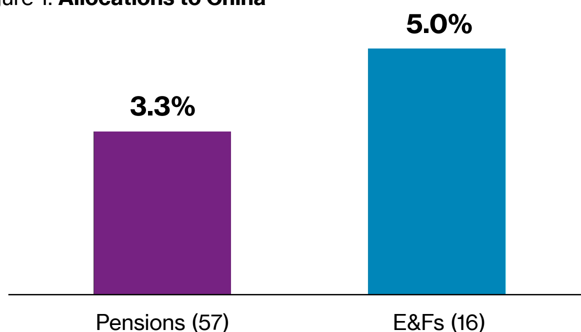
A standalone equity allocation to China can offer compelling diversification and potential excess return benefits for those with the ability to take advantage of this exciting opportunity set. In recent times many institutions have looked to access China via global or emerging market (EM) strategies. However, this approach may dilute the alpha potential and is not our preferred route.

Size and scale worthy of a standalone allocation

China is the second largest economy in the world, about 66% the size of the US, and contributing about 16% of global GDP in 2018[1]. Its equity market is the world's second largest by market capitalization, offering substantial breadth and depth in terms of the variety of listed companies and sector exposures, and it offers good liquidity potential. Despite this scale and breadth, China is underrepresented in most global investment portfolios.

According to a recent survey undertaken by Greenwich associates[2], pension funds and endowments have between 3 and 5% allocations to China, with European asset owners typically having less exposure than those surveyed who are based in North America. The authors of the survey go on to say that just 14% of asset owners globally, by number, and just 5% of North American institutions have any dedicated exposure to China's equity markets.

Figure 1: **Allocations to China**



Source: Greenwich Associates, as at 2019

[1]Source: International Monetary Fund (IMF), Organisation for Economic Cooperation and Development (OECD)
[2]Please refer to "Crafting the optimal China allocation strategy, The asset owner's perspective, Q2 2020" by Greenwich Associates and Matthews Asia

Why is the exposure to China so low?

Historically, the simple answer was that Chinese capital markets were closed to foreign investors. However, once they became more accessible investors were still reluctant to make explicit allocations. Some investors were of the view that because onshore China was not part of the standard global equity market indices (which are used to measure global equity portfolio performance) they simply did not need to make an allocation. Others, who could see the potential opportunity, preferred instead to give their EM or global equity managers an allowance to invest a portion of their portfolios in China. Further, given the relatively immature state of the onshore market, many were worried about finding high quality institutional grade managers that would meet their due diligence standards.

Today, China accounts for about 5% of the MSCI All Country World Index. For those anchored to indices, this suggests little need for a standalone allocation. By way of comparison, the US accounts for 55% of the Index.

That said, this is backward looking. We know the major index providers will substantially increase the allocation to China over the next 10 years.

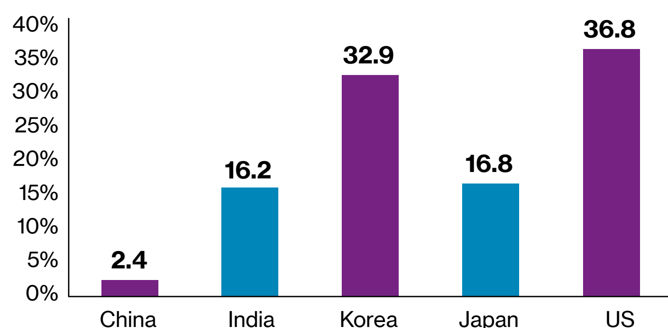
On a full market capitalization basis, China would account for about 20% of global indices, as of today.

When other countries entered such indices, there was a marked increase in foreign participation and investment flows. In our mind, it is better to be positioned ahead of this trend.

To illustrate this, we can see that foreign ownership of onshore Chinese equity markets is low compared to other major countries (see *Figure 2*). According to IMF data, foreign ownership in China, India, Japan, Korea and US equities markets are 2.4%, 16.2%, 16.8%, 32.9% and 36.8% respectively.

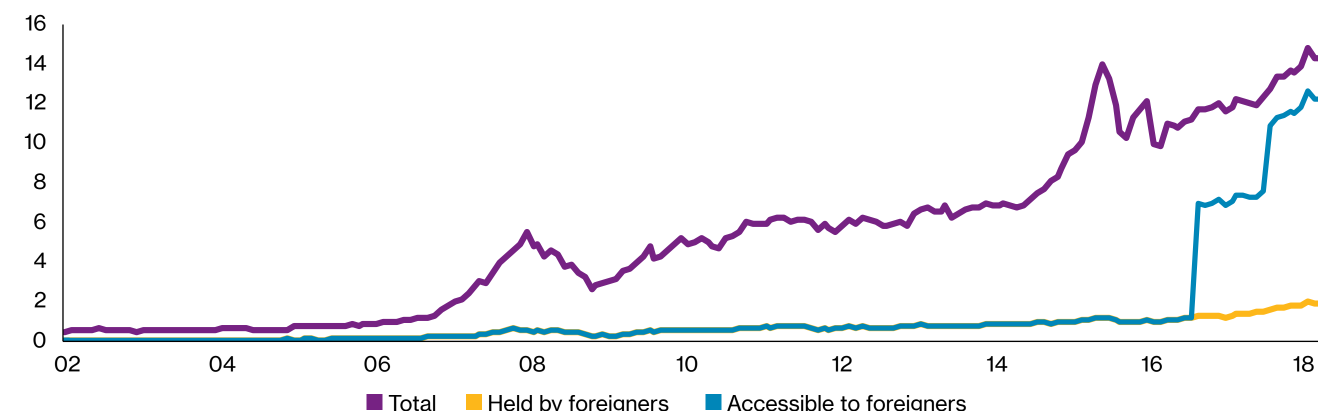
As mentioned earlier, the access to onshore Chinese markets has improved materially over the past 5 years. China launched the Hong Kong-Shanghai Stock Connect in 2014 and Hong Kong-Shenzhen Stock Connect in 2016. Given this, and because of the decision to include onshore China in various global and EM indices, we believe foreign ownership will increase markedly in the years to come.

Figure 2: **Stock market (foreign holdings as % of total market cap)**



Source: International Monetary Fund (IMF), 2018

Figure 3: **Size of onshore markets and their accessibility to foreign investors (US$ trillion)**



Source: MSCI, Bloomberg LP, Willis Towers Watson, 2019
For additional information please refer to "Considering Chinese assets. A valuable building block", Willis Towers Watson, 2019

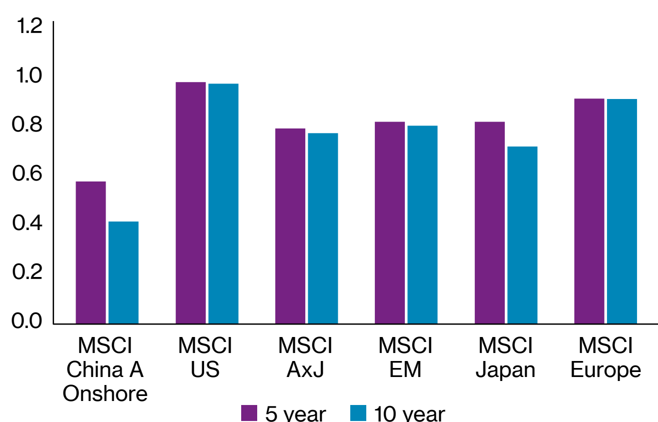
Diversification benefits

Chinese assets have historically exhibited low correlation with both developed markets and other emerging markets.

There are three reasons for this:

1. China was less connected with the global economy 20 years ago than today;
2. Capital restrictions had previously limited cross border flows, while foreign participation levels have been low; and
3. The Chinese domestic economic cycle runs at a different frequency to that of other regions, with policymakers focused on maintaining growth, employment and social stability. The tools used to transmit policy also vary, with less emphasis on interest rate policy, and more focus on credit supply, as well as fiscal measures.

Figure 4: **Equity returns: correlation to developed markets**



Source: MSCI, Bloomberg LP, Willis Towers Watson, data as at June 2020

The last point is very important from a capital allocation perspective. China is not just big; it is also very different when compared against other markets. The unique political and economic management regime means that simply adding China into an existing investment appraisal framework may not be appropriate and there is merit in considering new asset allocation frameworks where China is considered on a standalone basis.

While correlations have historically been low, we would expect they will slowly increase over time as the Chinese economy becomes more interlinked with the broader global economy, and investors allocate more capital into China. Nevertheless, we believe including a standalone allocation to onshore China in the equity portfolio should lead to an improvement in long-term risk-adjusted returns.

Alpha opportunities

In addition to substantial portfolio diversification benefits, we believe that the onshore China equity market provides attractive alpha opportunities for the reasons listed below.

Firstly, there is significant dispersion between both sectors and individual stock performance – selecting the winners and avoiding the losers can have a meaningful impact on portfolio returns.

Secondly, around 80% of trading volume is driven by retail investors[3]. This figure for US equity market is below 20%[4]. Compared with institutional investors, retail investors tend to have shorter investment horizons, are more momentum driven and less focused on corporate fundamentals. As a result, we have observed frequent sector rotations in China onshore equity market.

Figure 5: **MSCI China A Share Index Sector Performance (%)**

	YTD 2020	2019	2018	2017	2016	2015	2014	2013
Communication Services	19.02	27.03	-26.99	-11.73	-3.99	25.7	43.03	20.5
Consumer Discretionary	19.7	38.43	-33.55	22.54	-21.53	22.76	22.01	26.23
Consumer Staples	43.93	72.51	-24.5	73.49	-0.39	13.45	13.82	-3.25
Energy	-13.04	13.38	-26.36	11.37	-10.57	-21.33	18.14	-23.14
Financials	-0.98	36.66	-21.07	27.97	-12.39	-12.97	89.82	-2.47
Health Care	62.26	33.8	-30.14	21.12	-16.02	35.73	4.89	34.91
Industrials	16.29	23.63	-31.78	9.35	-23.78	12.2	52.31	6.05
Information Technology	40.45	59.18	-39.87	29.35	-29.06	48.05	9.56	45.14
Materials	15.82	25.27	-34.88	21.16	-17.59	1.58	35.51	-23.11
Real Estate	-4.79	30.23	-25.72	19.79	-23.31	30.62	77.04	-15.43
Utilities	0.28	4.5	-13.82	3.78	-22.56	2.94	82.15	2.54

Sources: Bloomberg LP, AGI, Willis Towers Watson
Past performance is not a reliable indicator of future returns

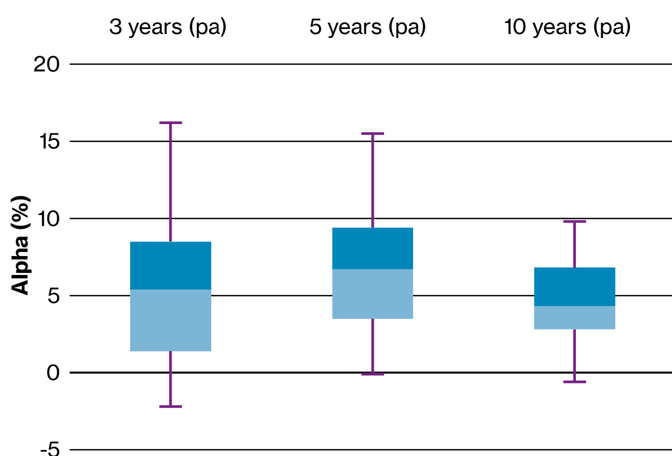
[3]Sources: Data from CEIC, Bank of America Merrill Ly nch, Wellington Management. Data as of 2016
[4]Sources: TABB Group, Wellington Management. Data as of 2017

While the prevalence of retail investors tends to exacerbate market volatility, with share prices over-shooting and under-shooting their fundamental values, this can also create a ripe market environment for institutional investors to take advantage of and deliver potential alpha (at the expense of those retail investors). Portfolio managers who can take a longer-term view, focus on fundamentals, and avoid companies with governance or other business challenges should benefit.

Our analysis has shown that active managers have been able to take advantage of market inefficiencies to help deliver good alpha, with the median manager outperforming the benchmark over most time horizons (between 4% and almost 7%), as seen in *Figure 6* below.

The extent of outperformance from the median manager shown in the analysis below is quite striking, especially when compared with developed and EM manager universes, which have not performed as well in recent times (*Figure 7*). Equally prominent is the dispersion of relative performance. The gap between 5th and 95th percentile manager performance can be more than 10% points per annum over 10 years.

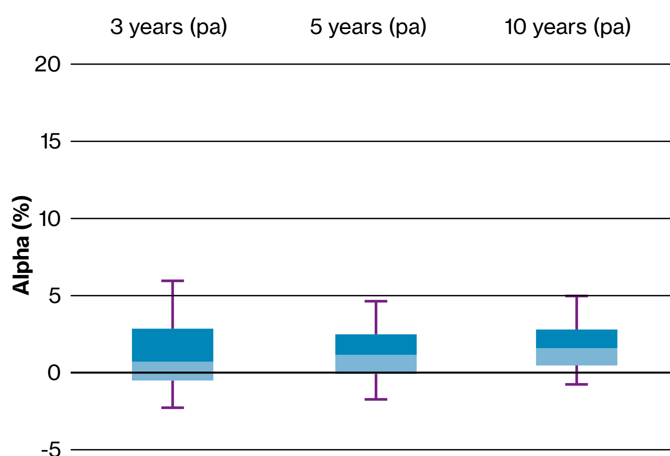
Figure 6: **China A managers tend to outperform benchmark**[5]



	Alpha (%)		
	3 years (pa)	5 years (pa)	10 years (pa)
5th percentile	16.2	15.5	9.8
25th percentile	8.5	9.4	6.8
50th percentile	5.4	6.7	4.3
75th percentile	1.4	3.5	2.8
95th percentile	-2.2	-0.1	-0.6
# observations	*50*	*47*	*20*

Source: based on eVestment's onshore China A-shares Equity universe. Data are as at 31 December 2019, net of fees and in USD terms. The benchmark adopted for the study is CSI 300 Index.

Figure 7: **The median EM manager alpha is notably lower than the China A median alpha**

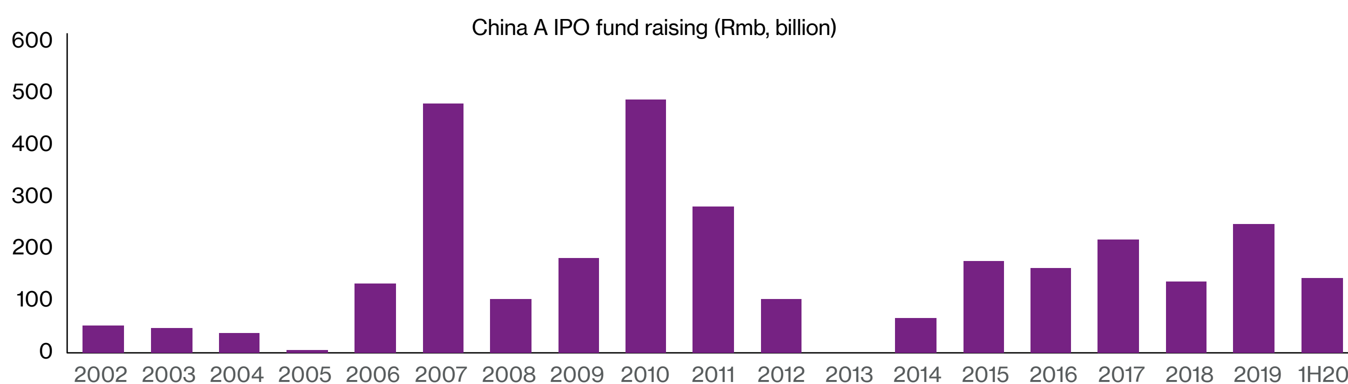


	Alpha (%)		
	3 years (pa)	5 years (pa)	10 years (pa)
5th percentile	5.9	4.6	5.0
25th percentile	2.8	2.5	2.8
50th percentile	0.7	1.2	1.6
75th percentile	-0.5	-0.1	0.5
95th percentile	-2.2	-1.7	-0.7
# observations	*430*	*374*	*177*

Source: based on eVestment's GEM Equity universe. Data are as at 31 December 2019, net of fees and in USD terms. The benchmark adopted for the study is MSCI EM Index.

[5]One might argue that the manager universe dataset is still emerging and that strong conclusions should be moderated because of issues such as small sample size, backfill bias and survivorship bias. There is some merit to this, however, our own experiences working with asset owners to allocate capital to the onshore Chinese market continues to validate our views – that dedicated managers can take advantage of an inefficient market to extract sizeable excess returns.

Figure 8: **IPO activity in the China A market**



Sources: Wind, Willis Towers Watson

We have considered additional factors which may have resulted in a particularly fertile environment for alpha in our research. Although the market continues to develop, it is still quite immature. There is often less information available to investors when making stock selection decisions, when compared with other geographies. For example, sell-side research coverage is substantially lighter on mid-cap stocks. Managers who have the resources, information networks, and expertise can bridge this gap to generate value.

One may also question the validity of the benchmark, and whether it is a useful reference point to compare performance against. We have some sympathy with this perspective and note that the market is extremely dynamic, with many new companies coming to market via IPOs as the Chinese economy further expands. Over the past decade the onshore Chinese equity market has often been among the top IPO markets globally. The result is a growing opportunity set that continues to develop, yet, it may take time for this to be reflected in the benchmark indices. Local expertise and knowledge are essential to navigate China's expanding and evolving opportunity set.

The evolution of the benchmark is evident in the changing sector makeup. Comparing CSI300 sector weights in 2005 and 2020, we have observed the market is transition from being more concentrated on manufacturing and materials companies towards more service led type of businesses. Weights of consumer, information technology and health have increased considerably.

Figure 9: **Sector weight of CSI 300 (2005 vs. 2020)**

Sector weight (%)	2005	2020
Financials	10.21	27.55
Consumer Staples	5.35	14.94
Information Technology	5.98	13.12
Industrials	16.72	10.67
Health Care	3.48	9.99
Consumer Discretionary	8.37	8.93
Materials	17.63	5.99
Real Estate	6.16	3.48
Communication Services	5.32	2.14
Utilities	9.31	1.83
Energy	5.73	1.36
Others	5.75	-
Total	**100.00**	**100.00**

Sources: Bloomberg LP, Willis Towers Watson

Typical investment approaches

Many investors today get access to China via global equity mandates, whereby the index (if passive) or manager has exposure to Chinese companies listed in Hong Kong (H shares), or the US (ADRs), or via multi-national corporates with sizeable revenues and profits generated in China.

Others look to get exposure via EM mandates, where the managers can tap into the stock connect program to access onshore China.

Interestingly, back in September 1996, when China was first included in the MSCI EM Index it had a weight of just 0.46%. Today, China is now the largest constituent geography in the Index.

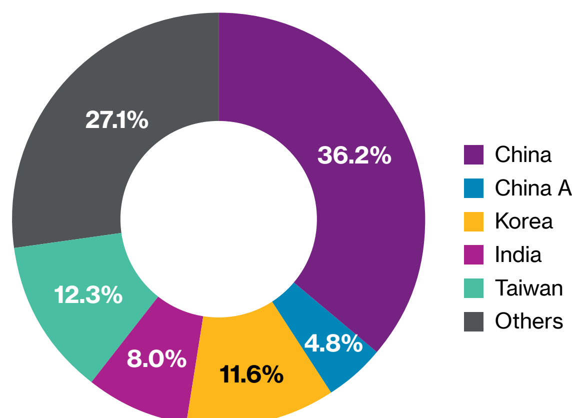
As of June 2020, China A and H shares, plus Taiwan accounted for more than 40% of the MSCI EM index. With potential future full A-share inclusion, the combined group will account for even more.

The analysis shown on *Figure 10* suggests that China will be the key driver of emerging market index and manager performance going forward. However, we question whether general emerging market managers are best placed to take advantage of this market opportunity.

In the 90s and 2000s, emerging market managers spent most of their time assessing investment opportunities spread evenly across the EM universe – EMEA, Latin and South America, as well as Asia. They did not have to spend much time researching the Chinese speaking world outside of Taiwan.

Our manager research team has observed that many managers exhibit strategic biases away from China – either

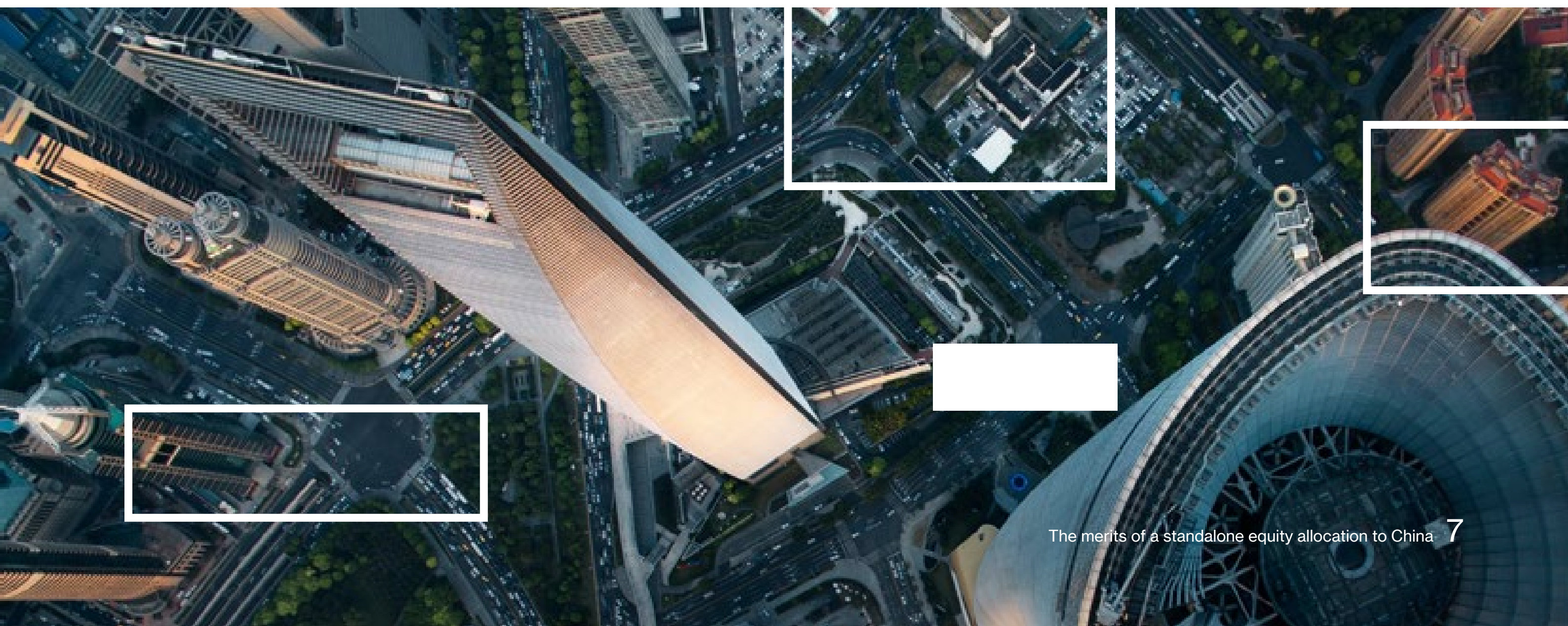
Figure 10: **MSCI Emerging Markets Index, 30 June 2020 (20% China A inclusion)**



Source: MSCI, as at end June 2020

because they don't like the market beta (due to perceptions around negative state influence, poor corporate governance and minority rights), or they don't understand the market very well beyond the mega caps (which in of itself is concerning given the large index weight now in China) and do not have the resources, an on the ground presence, or local expertise of Chinese markets to be able to take high conviction views. This is hugely important as most A-share company financial reports are in Chinese and company meetings are typically conducted in the local language. Further, government policy tends to have a bigger impact on sectors and overall equity market outcomes than in developed markets. Local expertise is essential to add insight, manage risks and generate alpha.

As of June 2020, with the current 20% China A share inclusion, China A share equity accounts for just 4.8% of MSCI EM Index and 0.6% of MSCI ACWI Index, concentrating on a few big cap stocks. Given the small weight, most EM and global equity managers do not have the resourcing and skill to navigate the opportunity set properly. Hence accessing China through EM or global equity mandates is not our preferred implementation route.



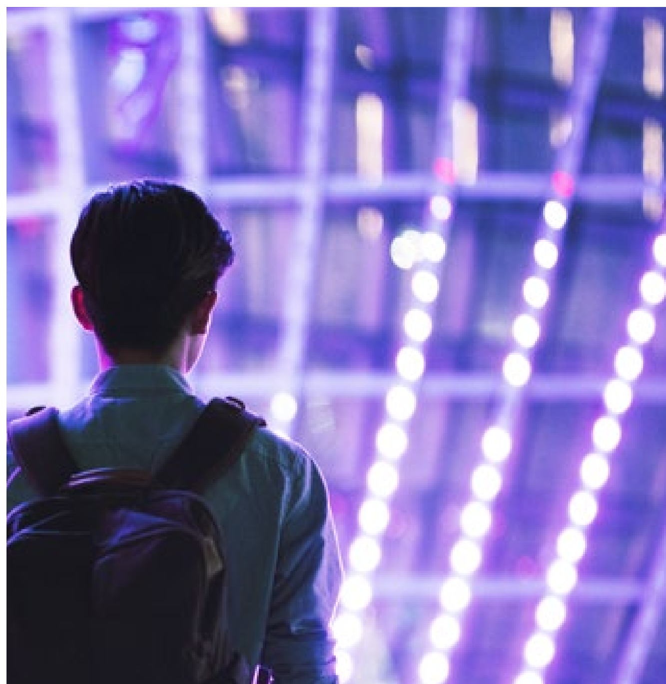
Portfolio positioning

In this paper we have shown that the China A share market offers a dynamic and broad opportunity set. With significant improvements in accessibility, we expect the overall allocation in international investor portfolios to increase substantially in the years ahead. Chinese equities offer compelling diversification and excess return benefits. To fully benefit from the sizeable alpha opportunity asset owners should now consider Chinese equities as a stand-alone allocation.

The sizing of the exposure will depend on each individual investor's beliefs and perspectives regarding the attractiveness of the opportunity set relative to developed and emerging markets – the standard asset allocation framework adopted by many asset owners. At present, the Willis Towers Watson global equity model portfolio has a strategic allocation of between 10% and 12.5% of the portfolio in dedicated China A share mandates – substantially more than the current weight in China A shares in the MSCI ACWI benchmark.

Figure 11: **Current model portfolio exposure to China A shares**

Exposure	WTW model portfolio
Developed markets	77.5% - 82.5%
Emerging markets	7.5% - 10%
China A	10% - 12.5%



Our experience researching Chinese strategies

While we strongly recommend active management as the preferred way to access China, asset owners must be extremely careful when selecting their asset managers, as the dispersion between manager performance can be substantial (as seen in *Figure 6*).

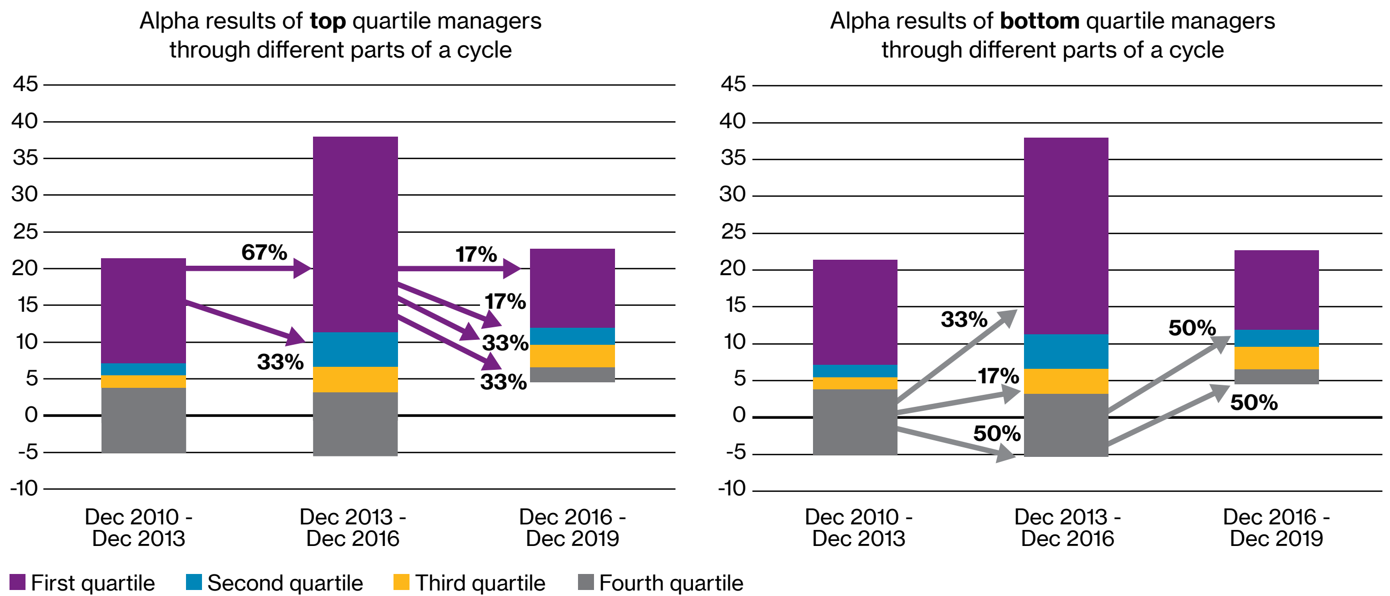
We have been researching Chinese equity managers for over 20 years now, initially covering offshore/H-share strategies, and adding A-share strategies over the last decade. In 2011 we brought several asset owners to China to visit key policymakers and meet with managers. Following this in early 2012, we wrote about how investors could access China, and the opportunity set.

We have research on most asset managers who offer institutional grade strategies, and a line-up of several preferred managers currently being used by our advisory and delegated client base. In total, over the last 3 years we have helped to allocate more than US$8 billion in client assets.

China A managers rated *"Preferred"* by Willis Towers Watson have on average delivered an annualized 7% net alpha over the past 5 years, to end December 2019. We believe clients who have followed our recommendations and implemented multi-manager portfolios could have experienced a more stable alpha pro file when compared against the average China A manager.

Our scale also means we have been able to negotiate sizeable fee discounts when compared against standard off-the-shelf rack rates, and this has contributed positively to the overall net return experience.

Figure 12: **Alpha results of top quartile managers and bottom quartile managers over time**



Source: based on eVestment's onshore China A-shares Equity universe. Data are as at 31 December 2019, net of fees and in USD terms. The benchmark adopted for the study is CSI 300 Index. 23 observations in total.

It has not been an easy journey, but one we are proud of. Along the way we have developed many learnings and insights which are key in forming our recommendations to clients.

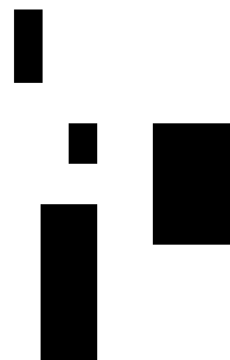
For example, oftentimes we see strategies where the experience of the key portfolio manager is less than 10 years, or there is an inconsistent investment process being applied to stock selection, portfolio construction and risk management, whereas excessively high portfolio turnover typically indicates a short-term trading mindset permeates the manager's strategy.

In many other cases we see poor capacity management, and weak alignment of interest between the manager and asset owners. Many onshore managers are backed by state-owned enterprises, there is typically no employee ownership, weak long-term remuneration incentives, and there is evidence of high personnel turnover. While offshore based managers tend to run more disciplined strategies, we also must look at the extent of their local on-the-ground presence, access to information and the overall quality of their research on companies below the large cap spectrum.

As shown earlier, we have observed that the median manager has typically outperformed. However, the composition of managers in each performance quartile varies through time, sometimes quite substantially. In many cases, we see manages who deliver outstanding results over 1-3 years do very poorly in subsequent years, and vice versa. Past performance has been an extremely unreliable indicator to identify skilled managers. For Willis Towers Watson, the key is to find managers who can deliver good levels of alpha, sustainably over time, who follow a disciplined and risk aware approach.

All the above suggests there is a need for substantial investment and operational due diligence. This should be complemented by an assessment of culture and environmental, social and Governance (ESG) factors. There have been several occasions where managers have failed our due diligence because of weak culture and ESG scores.

While there are many challenges when researching China equity strategies, we believe the benefits are worthwhile.

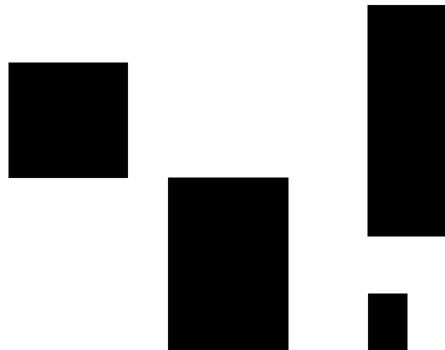


For more information please contact

Paul Colwell, CFA
Head of Advisory Portfolio Group, Asia
paul.colwell@willistowerswatson.com

Claire Shen, CFA
Manager Research, Asia
claire.shen@willistowerswatson.com

Liang Yin, PhD, CFA
Thinking Ahead Group
liang.yin@willistowerswatson.com



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