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In focus

Should investors adapt their approach to investing in Chinese equities?

May 2024

The debate around how investors should allocate to China has grown in recent years. Should they continue to include it as part of a global emerging market (EM) equity allocation, or carve the country out from EM and allocate on a standalone basis?

There are pros and cons to both approaches, each of which may carry greater weight depending on an investor's objectives and constraints. As such, both have validity, but what's crucial is that the decision on which path to take is made following an informed assessment.

In this paper we cover the drivers of the China allocation debate, discuss the pros and cons, review the key characteristics of Chinese equities, and highlight the main differences between the EM and EM ex China indices.

Kirsty McLaren
Investment Director

What is driving the debate around how to allocate to China?

Despite recent market weakness, China is by far the largest component of EM benchmark indices. As of the end of March 2024, it accounted for about 25% of the MSCI Emerging Markets Index; the next biggest markets being India at 18%, Taiwan, 18%, and South Korea, 13%.

Standalone China funds have become more popular with investors, particularly in the last few years since the domestic market became more easily accessible to foreigners.

Today, standard practice is to include China within a global EM allocation. However, more recently, many EM ex China strategies have launched. There are two key drivers behind this:

1. China's size has prompted a desire from some investors to allocate to a specialist manager, while allowing a broad EM manager to focus on delivering ex China returns.
2. Asset owners' desire to take control of their China allocation and therefore China risk themselves.

Figure 1: China approaches compared

	EM including China	EM ex China plus standalone China
Does investor require or desire China investment visibility and control?	No control and limited visibility over amount invested in China	Control and visibility over amount invested in China
Allocation decision	One EM allocation decision: – Leave China vs. EM allocation to EM manager	Two EM allocation decisions – Retain responsibility for China vs. rest of EM decision
Manager search	One search process	Two search processes
Fees	Opportunity for scale economies/ bargaining power maximised	Scale economies may not be achieved
Manager monitoring	One manager	Two managers
Alpha generation in China	Broad EM manager may: – Leverage insights from wider EM universe to China stock selection – Overlook interesting parts of Chinese market in favour of other EM	Specialist China manager: – Offers dedicated China resource with consistent focus on the market so has the potential to exploit wide range of investment opportunities
Risk management	Holistic view of risk exposures across EM	Separate risk views may lead to suboptimal risk exposures given linkages between China and other EM

Source: Schroders, April 2024.

There are benefits to both approaches, depending on investor objectives and constraints/preferences. The fundamental question is whether the investor wants to retain direct control of their China allocation. Do they have a strong investment view on China? Do other factors drive a need for greater control?

A single allocation to EM including China minimises the costs to the investor in terms of search, monitoring and fees compared to an EM ex China plus standalone China approach. It also unifies risk management across EM equities. However, for a large, sophisticated investor with extensive resources, cost differences are unlikely to be meaningful.

In the end, whether EM ex China plus standalone China is a more expensive approach than a standard EM including China net of fees hinges on two key factors: i) Whether a specialist China manager outperforms a broad EM manager within China (i.e. alpha generation net of allocation effect) over the investment horizon, ii) Whether the investor's decision making in under/overweighting China is superior to that of the broad EM manager.

There is also a third option available to investors with a segregated mandate who are concerned about the dominance of China within EM. They can customise their benchmark and cap the allocation to China.

A historical comparison – Japan's experience

- Japan used to be part of a single Pacific or Asia Pacific regional equity allocation
- Starting in the 1990s, other Asian markets eased foreign ownership restrictions and began to be included in regional benchmarks
- Japan remained by far the largest Asian equity market and dominated regional indices
- The long-term outlook for Japan and the rest of the Asia began to diverge in the 1990s. This was Japan's lost decade after the 1980s credit bubble burst. It also saw the rise of the Asian tigers
- Demand for Asia ex Japan investment products began to rise with Japan allocations increasingly serviced by specialist managers
- This is now the dominant approach to investing in the region. For example, Morningstar lists four times as many Asia/Pacific ex Japan than Asia/Pacific inc Japan funds sold in Europe, and in terms of AUM, the ex Japan group is eight times bigger

The key characteristics of China's stock market

Over the last two decades, one of the most significant developments in global equity markets has been China's opening up to foreign investors.

In the early 2000s, foreigners typically invested in Chinese companies through H shares and Red Chips. These Hong Kong Special Administrative Region (SAR) listed securities represented only a tiny proportion of mainland companies. China's domestic A share market was completely closed to foreigners. The B share market, reserved for foreigners, was heavily restricted and effectively dormant. The various Chinese share classes are described in figure 2 below.

Figure 2: Chinese share classes explained

Share Class	Listing	Description	Trading Currency	Available to non-mainland Chinese investors
A Share	Shanghai, Shenzhen	Securities of Chinese incorporated companies.	CNY	Under QFI[1]/ Stock Connect programmes
B Share	Shanghai, Shenzhen	Chinese incorporated companies listed on either the Shanghai or Shenzhen stock exchanges that can be traded by non-residents of the PRC and PRC residents with appropriate dealing accounts.	USD (Shanghai) HKD (Shenzhen)	Yes
H Share	Hong Kong SAR	Securities of Chinese incorporated companies.	HKD	Yes
N Share	NYSE, NASDAQ, NYSE MKT	Incorporated outside the PRC and controlled by mainland Chinese entities, companies or individuals, with a majority of their revenue or assets derived from the PRC.	USD	Yes
P Chip	Hong Kong SAR	Incorporated outside the PRC and controlled by mainland individuals with a majority of their revenue or assets derived from the PRC.	HKD	Yes
Red Chip	Hong Kong SAR	Incorporated outside the PRC and substantially owned by mainland China state entities with the majority of revenues or assets derived from the PRC.	HKD	Yes
S Chip	Singapore	Incorporated outside the PRC and controlled by mainland Chinese entities, companies or individuals, with a majority of their revenue or assets derived from the PRC.	SGD	Yes

Source: FTSE Russell Guide to Chinese Share Classes v2.1, October 2023.

[1]QFI (Qualified Foreign Investor) scheme resulted from the merger of the QFII (Qualified Foreign Institutional Investor) and RQFII programmes in 2020. QFII, set up in 2002, was the original route into China's onshore markets, with a RMB denominated scheme, RQFII (RMB Qualified Foreign Institutional Investor), following in 2011. These schemes fell out of favour after Stock Connect opened.

Foreign investing in China was transformed after Stock Connect launched in 2014. This investment channel linked the Hong Kong Stock Exchange with the Shanghai Stock Exchange, permitting investors in each market to trade shares on the other market using their local brokers and clearing houses. In 2016, Stock Connect was expanded to include the Shenzhen Stock Exchange.

Starting in 2018, A shares were included in the MSCI Emerging Markets index in three phases, limited to 20% of free float adjusted market capitalisation.[2] This, plus strong performance during the early stages of the Covid-19 pandemic, helped China reach a peak share of 43% of the MSCI EM index in 2020. China's share has since fallen back as a combination of regulatory clampdowns on internet platform companies and the private education sector, strains in the real estate sector, and the prolonged zero-Covid policy led Chinese equities to underperform broader EM.

Figure 3: China's share of emerging markets

Weight in MSCI Emerging Markets Index

Source: FactSet as at 31 March 2024.

China's domestic stock market is one of the biggest in the world and offers a large and liquid opportunity set. Measured by market capitalisation in US dollar terms, Shanghai is the fifth largest exchange in the world, behind the NYSE, NASDAQ, Euronext and Japan, and Shenzhen is in seventh place.[3] Both the Shanghai and Shenzhen Stock Exchanges host more than 2,000 listed companies.[4] China's stock markets are dominated by domestic investors, with foreigners holding around 10% of the listed equities on each exchange.

As figure 4 shows, there are a wide selection of stocks available across the market cap spectrum.

Figure 4: Number of mainland China listed companies

Market cap range	Shanghai	Shenzhen
>$50bn	14	4
$25–50bn	14	8
$10–25bn	78	39
Large cap	**106**	**51**
$5–10bn	105	69
$2–5bn	330	281
Mid cap	**435**	**350**
<=$2bn	1,801	2,542
Small cap	**1,801**	**2,542**

Source: Refinitiv as at 31 March 2024.

[2]The official foreign ownership limit for China A share securities is 30%, however, once the foreign ownership level reaches 28% no further foreign purchases are permitted. Once the foreign ownership level falls back below 26%, new foreign buy orders are accepted.

[3]World Federation of Exchanges, as at March 2024.

[4]As at March 2024.

Figure 5 shows some key liquidity metrics of China-listed stocks. A few points stand out:

– The average free float is near 50% in Shanghai and slightly higher in Shenzhen. This is an indicator of good market liquidity. (The average free float of the Shanghai-listed mega caps is much lower due to the presence of state-owned banks and energy companies)

– Average daily traded value is high across the market cap spectrum and increases as market cap decreases. Relatively smaller stocks are particularly actively traded

Figure 5: Liquidity characteristics of Chinese stocks

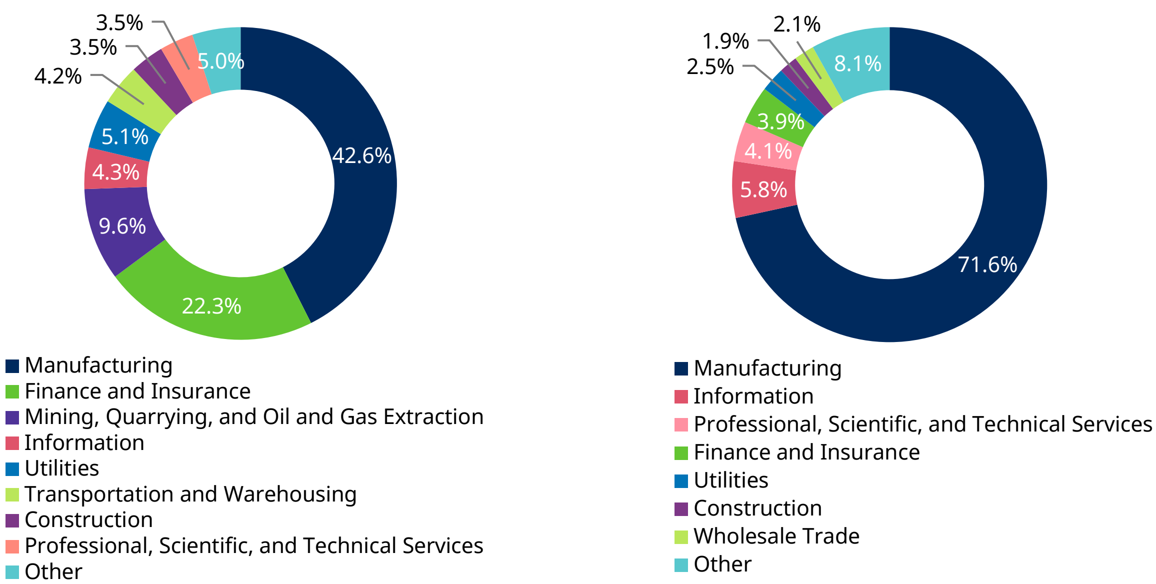
Exchange	Shanghai						Shenzhen					
	Large cap		Mid cap			Small cap	Large cap		Mid cap			Small cap
Market cap range	**>$50bn**	**$25–50bn**	**$10–25bn**	**$5–10bn**	**$2–5bn**	**<=$2bn**	**>$50bn**	**$25–50bn**	**$10–25bn**	**$5–10bn**	**$2–5bn**	**<=$2bn**
Average daily traded value 6m ($m)	2,982	1,364	7,446	5,460	10,028	23,096	1,493	1,559	4,711	6,453	13,433	41,116
Average free float	27%	44%	48%	47%	49%	52%	56%	58%	53%	53%	58%	57%
Total free float ($bn)	428	215	596	347	501	641	175	155	317	252	475	915
Total market cap ($bn)	1,704	469	1,243	741	1,024	1,259	311	275	589	476	831	1,616

Source: Refinitiv as at 31 March 2024.

The manufacturing sector represents the largest share of companies on both exchanges, reflecting China's successful investment-led growth model and its role as the world's factory.

Figure 6: Industry breakdown of listed companies

Shanghai Exchange – industry weights **Shenzhen Exchange – industry weights**



Source: FactSet and Refinitiv as at 31 March 2024. Based on North American Industry Classification System (NAICS). Other are industry weights less than 2%.

Retail investors

Owing to capital restrictions, China has a large pool of trapped domestic capital. Individuals in China typically have three investment choices – they can put their money into banks, real estate, or the stock market. This, along with a nascent institutional asset management industry, means that retail trading activity proliferates in China. At times it has accounted for up to 80% of the total domestic market volume. As retail investors often have shorter time horizons than other investor groups and may overreact to news flow, this can result in stocks being significantly over or undervalued for periods of time.

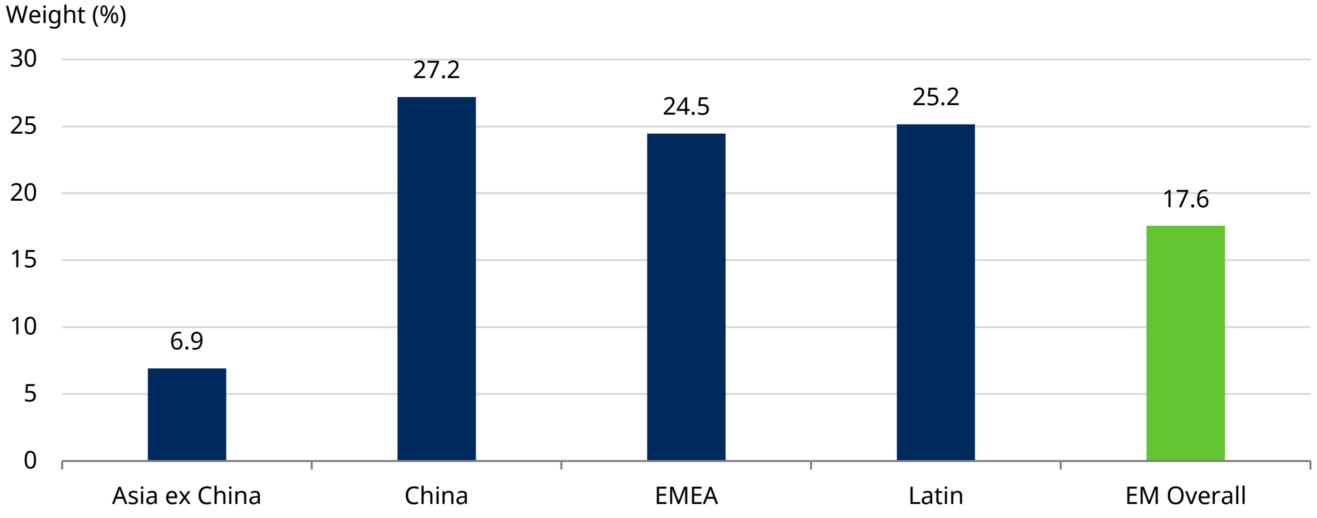
The high participation rate of retail investors reduces the overall efficiency of the market and provides opportunities for more sophisticated investors with rigorous investment processes and longer investment horizons to generate alpha. Despite some recent challenges, China's domestic equity market has historically been a fertile ground for institutional investors to generate alpha.

State-owned enterprises

Another factor in overall market efficiency is the prevalence of state-owned enterprises (SOEs). SOEs are widespread in EM and China is a prime example of this. As figure 7 shows, the share of SOEs in China is much higher than in the rest of Asia. The issue here is that the controlling shareholder may have priorities other than maximising shareholder returns. An active manager may be able to anticipate when the state's interests will be aligned with minorities and when they will diverge.

Figure 7: Weight of SOEs in emerging markets

Weight in MSCI Emerging Markets Index



Source: FactSet, MSCI as at 31 March 2024.

Regulatory activity

The last few years has seen a flurry of regulatory activity in China. Several factors have been behind this. Alongside China's huge economic success, inequality has been rising. Regulation is partly a desire to see economic gain more widely spread, in line with a stated focus on 'common prosperity'.

The pace of innovation, particularly in areas such as e-commerce has run ahead of legislation, a theme we've seen unfold in developed markets, especially in relation to internet economy companies. There is a need in certain circumstances for stricter regulation.

There are also the strategic goals of the state, with which companies increasingly need to align. Geopolitical issues are affecting China's access to leading edge technology. So, China has a strong desire to move towards technology self-sufficiency. There is huge intellectual and financial capacity in the private sector to support that ongoing push.

Broadly speaking, the main thrust of regulatory activity has been on antitrust, issues of inequality, gig economy labour practices etc. This has wide ranging impacts for sectors such as property, healthcare, education, financial services, and e-commerce.

Generally, regulation drives uncertainty, which in turn drives a higher risk premium and potentially the suppression of returns.

Sustainability reporting

China has set an ambition to reach peak carbon by 2030 and become carbon neutral by 2060. Corporate ESG reporting plays an important role in monitoring and managing this process and China has made no secret of its desire eventually to adopt mandatory ESG disclosure requirements. Although ESG reporting requirements in China are currently minimal[5], listed companies have been encouraged to disclose ESG information since 2018. As of mid-2020, 1,021 Shanghai and Shenzhen-listed companies published annual CSR/ESG reports, up from 371 companies in 2009.[6] Among larger companies, disclosure is better, with 86% of CSI 300 constituents (the 300 largest and most liquid A-shares) publishing ESG reports in 2020.

The trend is clearly positive and, with the addition of mandatory disclosure requirements, should help investors to gather higher quality data and better incorporate ESG considerations in their investment process.

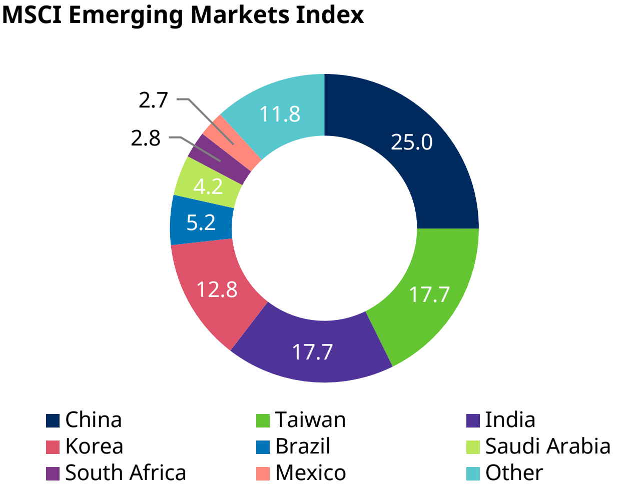
Chinese A shares clearly present a rich opportunity set, albeit one that comes with multiple challenges for foreign investors, who are still very much minority participants in China's domestic stock market.

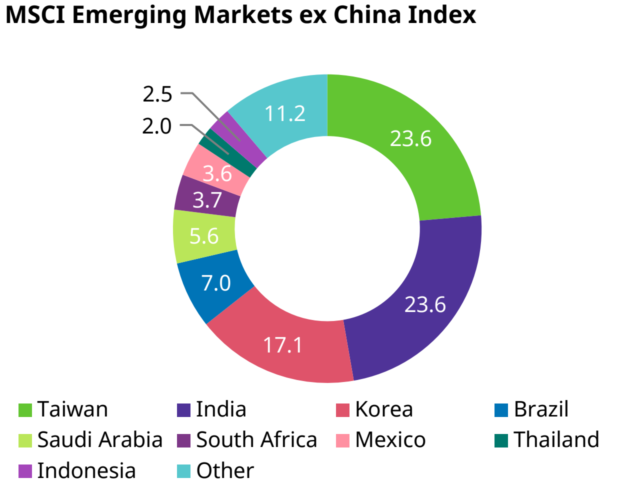
Next, we examine how the investment landscape changes if we remove China from the EM universe. This analysis is based on a comparison of the MSCI EM and MSCI EM ex China indices. MSCI launched its EM index in 1987, and the MSCI EM ex China index followed in 2017.

How does EM ex China compare to EM?

After China, the three largest countries in EM are India, Taiwan, and South Korea. As shown in figure 8, they are the main share gainers in a shift to MSCI EM ex China, accounting for an aggregate 64% of that index compared to their 48% share of the MSCI EM index. When China is excluded, the index weight of North Asia falls from 60% to 47%.

Figure 8: MSCI EM versus MSCI EM ex China – country exposures





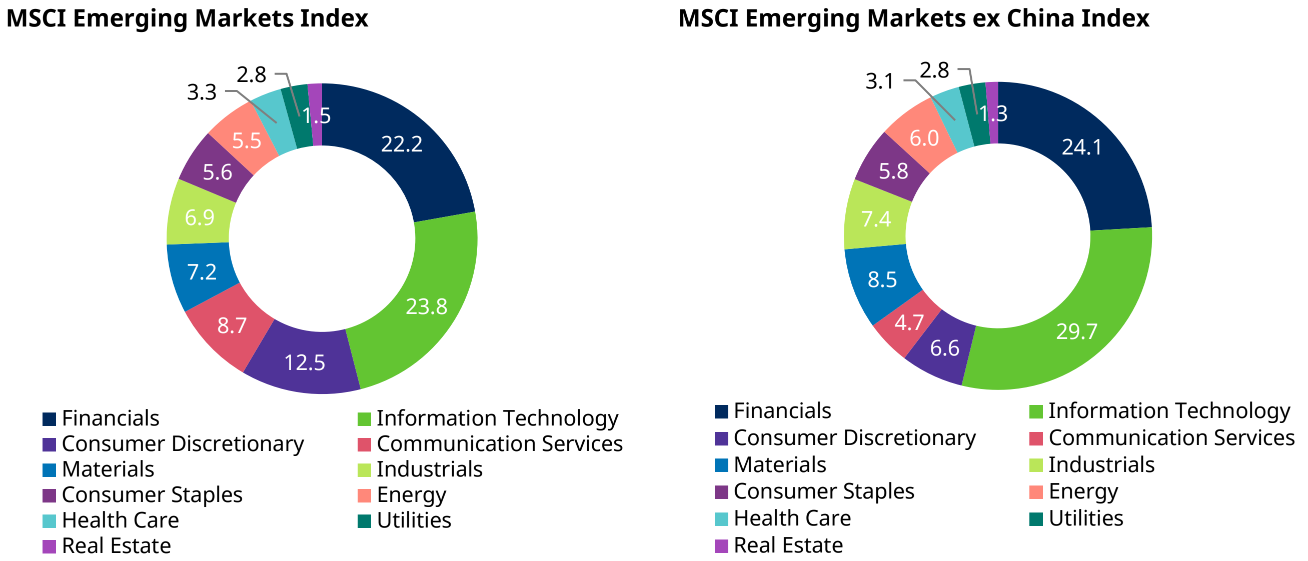
Source: FactSet as at 31 March 2024. Other comprises countries with index weights less than 2%.

As shown in figure 9, on a sector basis, EM ex China has a greater exposure to IT, due to the higher weight of South Korea and Taiwan and, due to the absence of the Chinese internet companies, lower exposures to consumer discretionary and communication services.

[5]The only mandatory requirement was introduced in 2022 by the Ministry of Ecology and Environment. This requires companies that are considered to be major emitters of pollutants and publicly traded companies that have been penalised for environmental violations within the last year to provide a range of environmental information annually.

[6]World Economic Forum "Is Chinese business on the cusp of a 'leapfrog moment' in ESG reporting?" (25 Mar 2021).

Figure 9: MSCI EM versus MSCI EM ex China – sector exposures



Source: FactSet as at 31 March 2024.

China represents a large pool of stocks. As shown in figure 10, excluding China from EM removes securities across the market spectrum but does not change the shape of the index. It does, however, notably shrink the numbers of very large and very small stocks. In total, the number of index stocks falls from 1,374 to 671; a fall of 51% once China is excluded from EM.

Figure 10: MSCI EM versus MSCI EM ex China – market cap breakdown

31 March 2024	MSCI EM		MSCI EM ex China	
Market Capitalisation	**# of Securities**	**Index Weight**	**# of Securities**	**Index Weight**
>$50bn	55	37.2%	33	36.2%
$25–50bn	88	15.5%	55	15.2%
$10–25bn	302	23.6%	173	25.2%
$5–10bn	403	14.7%	218	15.4%
$2–5bn	485	8.4%	190	7.9%
<$2bn	41	0.6%	2	0.0%
Largest (m)		**1,983,702**		**1,983,702**
Smallest (m)		**286**		**543**
Mean (m)		**14,789**		**17,852**
Median (m)		**6,496**		**7,753**

Source: Schroders, FactSet, as at 31 March 2024.

This is apparent in the liquidity characteristics of the two indices, with the MSCI EM ex China significantly less liquid than the MSCI EM index.

Figure 11: MSCI EM versus MSCI EM ex China – liquidity characteristics

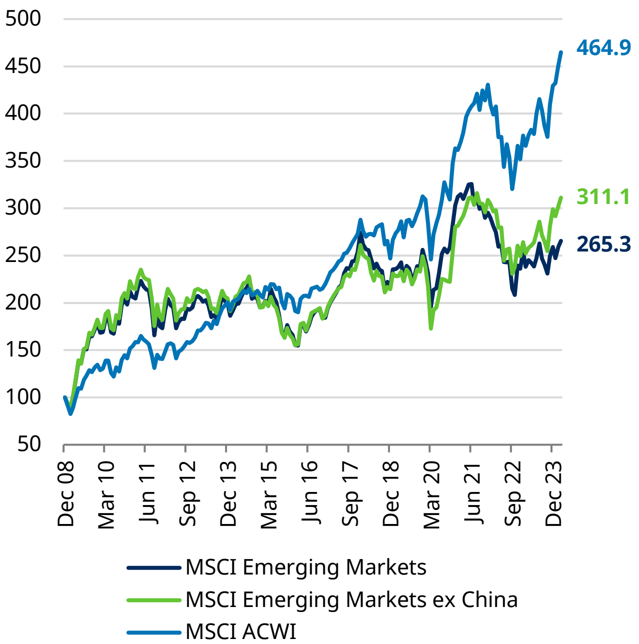
31 March 2024	MSCI EM			MSCI EM ex China		
	# of Securities	Index Weight	6m ADV	# of Securities	Index Weight	6m ADV
> 500m	9	17.9%	6,723.5	3	17.3%	2,483.0
100–500m	148	17.7%	27,704.5	40	11.1%	7,504.7
50–100m	190	10.4%	13,360.6	47	9.1%	3,378.1
30–50m	204	10.2%	7,926.1	65	10.3%	2,496.0
20–30m	203	7.5%	4,927.6	70	7.7%	1,686.6
10–20m	228	12.3%	3,313.2	129	14.3%	1,841.8
5–10m	170	9.2%	1,232.3	124	11.0%	884.6
< 5m	222	14.8%	539.3	193	19.1%	438.6
Total	**1,374**	**100.0%**	**65,727.1**	671	100.0%	20,713.4
Average			**8,215.9**			**2,589.2**

Source: Schroders, FactSet, data to 31 March 2024. Average daily value (ADV) traded figures are for previous 6 months in USD millions.

Relative performance is significantly influenced by China's poor performance in the last three years. On a three-year basis to end March 2024, EM ex China has returned 22% per annum compared to MSCI EM's -5.1%. On a longer time horizon, China has done better. Over 10 years, the annual returns have been 4.2% and 2.9% respectively. And since the end of 2000, the annual returns have been very similar, with EM ex China returning 8.1% compared to MSCI EM's 7.6%.[7]

Figure 12: Cumulative index performance

Net returns (USD)



Annual performance (%)

Year	MSCI Emerging Markets ex China	MSCI Emerging Markets	MSCI ACWI
2023	20.0	9.8	22.2
2022	-19.3	-20.1	-18.4
2021	10.0	-2.5	18.5
2020	12.5	18.3	16.3
2019	16.2	18.4	26.6
2018	-12.4	-14.6	-9.4
2017	31.2	37.3	24.0
2016	15.0	11.2	7.9
2015	-16.9	-14.9	-2.4
2014	-4.6	-2.2	4.2
2013	-4.0	-2.6	22.8
2012	17.2	18.2	16.1
2011	-18.4	-18.4	-7.3
2010	22.3	18.9	12.7

Source: FactSet and MSCI, as at 31 March 2024. Total return, net US dollars.

Performance shown is past performance. Past performance is not a guide to future performance and may not be repeated. The value of investment can go down as well as up and is not guaranteed.

[7]To end March 2024, total return, net US dollars.

What does this mean for investors?

Many investors have been reassessing their approach to investing in China. In part this is prompted by disappointing recent performance and ongoing headlines around US-China tensions and concerns around de-globalisation.
The inevitable slowing of Chinese economic growth as the investment-led model that has been so successful over the last two decades reaches a natural limit has also been a factor.

Recognising China's dominant size in EM, some investors have begun to question whether they should have a separate allocation to a specialist China manager rather than rely on a single allocation to an EM manager who includes China.

In our view, both approaches have validity. So long as the investor is aware of the pros and cons of each approach, they can make an informed decision that accommodates their own preferences.

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