



EQUITIES

How to Approach a More Accessible Chinese Equity Market

BARINGS INSIGHTS

As China continues to open up its capital markets to international investors and its representation in the global equity opportunity set expands, there is no doubt that investors are on the cusp of an exciting chapter for Chinese equities. Historically a closed asset class, China A-shares have become more accessible to global investors as the Chinese government introduced a number of measures to encourage foreign participation. Barings' Head of Hong Kong China Equities, William Fong, and Client Portfolio Manager, Andrew Lee, explain more about the asset class, and how investors should approach it.

Introduction

Home to some of the world's largest and fastest-growing companies, the Chinese equity market has expanded exponentially in recent years. With onshore China A-shares being incrementally added to global indexes, together with the Chinese companies listed in the offshore stock exchanges, Chinese equities now hold a much more significant representation within the global equity opportunity set. In this paper, we explore the different ways to access China's onshore and offshore equity markets, our investment view on the asset class and the strategies Barings currently offer to specifically tap into the growth opportunities embedded within the second-largest equity market in the world.

FIGURE 1: The Different Methods of Accessing China A-Shares

	QFII	RQFII	Stock Connected Northbound	
			SH-HK Connect	SZ-HK Connect
Launch Time	November 2002	December 2011	November 2014	December 2016
Investment Scope in A-Shares	<ul style="list-style-type: none"> All stocks listed in Shanghai and Shenzhen Primary market activities such as IPO, additional shares issuance and seasoned equity offerings 		<ul style="list-style-type: none"> Constituents of SSE 180 Index and SSE 380 Index Any listed A- with dual listed H-share (except shares not traded in RMB or under risk alert) Secondary market and rights issues, not IPOs Currently 579 stocks eligible for buy/sell 	<ul style="list-style-type: none"> Constituents of SZSE Component Index and Small/Mid Cap Innovation Index with market cap \geq RMB 6bn Any listed A- with dual listed H-share (except shares not traded in RMB or under risk alert) Secondary market and rights issues, but not IPOs Currently 740 stocks eligible for buy/sell
Eligible Institutional Investors	Qualified foreign institutional investors pre-approved by CSRC and SAFE		All Hong Kong and Overseas investors (including hedge funds) can trade through Northbound link	
Investment Quota	Base quota linked to AUM size; additional quota subject to SAFE (State Administration of Foreign Exchange) approval. Quota is not transferrable		Subject to northbound daily quota of RMB 52bn	Subject to northbound daily quota of RMB 52bn
Transaction Currencies	USD and other foreign currencies	RMB	RMB	RMB
Capital Mobility	<ul style="list-style-type: none"> Rules of 3-month lock-up period and 20% repatriation limit of investment principal and profits were removed in June 2018 (although SAFE could still impose temporary restriction on QFII repatriation if needed) Quota could be retracted partially or wholly by SAFE if unused after 1 year since approval granted 	<ul style="list-style-type: none"> 3-month lock-up period for non-open-end funds was removed in June 2018 No repatriation limit Quota could be retracted partially or wholly by SAFE if unused after 1 year since approval granted 	<ul style="list-style-type: none"> Less constrained capital mobility but still subject to daily quota limit Trading only available on days where both markets are open and banking services are available on the corresponding settlement days Stock coverage on smaller caps is still less comprehensive 	

SOURCE: HKEx, China Securities Regulatory Commission, State Administration of Foreign Exchange, MSCI, Barings. As of February 2019.

What's the Difference Between China A and H-Shares?

China A-shares are onshore-listed Chinese equities, trading in renminbi (CNY) on the Shanghai Stock Exchange and Shenzhen Stock Exchange. Historically, they have been inaccessible to all investors outside of mainland China. China H-shares are publicly traded Chinese companies listed offshore, on the Hong Kong Stock Exchange, which is open for trading to all investors.

Things began to change in 2002 when China A-shares first became available to foreign investors through the inauguration of the Qualified Foreign Institution Investor (QFII) program, which allowed investment into the onshore market via a quota system.

The Renminbi Qualified Foreign Institution Investor (RQFII) program was subsequently established in 2011, representing a gradual loosening of China's capital controls and departure from its predecessor. The RQFII relaxed the existing restrictions on areas including currency settlement, capital lock-up period and repatriation, and it also introduced permissible asset classes and expanded investor eligibility. That being said, investment rules for both programs were incrementally relaxed and harmonized over time, making it a lot less restrictive for foreign investors to participate.

Foreign access to the onshore market was greatly enhanced with the launch of the Shanghai-Hong Kong Stock Connect in November 2014, followed by the implementation of the Shenzhen-Hong Kong Stock Connect in December 2016. This introduced cross-boundary investment channels which connected the different exchanges and ultimately enabled investors in each market to trade shares listed in the other market using their local brokers and clearing houses. The establishment of the Stock Connect program eventually became a significant milestone on the path to having A-shares being included in MSCI indices in 2018.

Approval by China's State Administration of Foreign Exchange (SAFE) will be required for QFII/RQFII application, and the final quota allotted will be linked to the asset size or investment requirement of licensed investors. While no approval process is required for Stock Connect, it carries a daily investment quota for both northbound (investing into onshore China) and southbound (investing into Hong Kong) trading.

FIGURE 2: Hong Kong China Equity Markets Overview

	Hong Kong Exchange		Shanghai Stock Exchange		Shenzhen Stock Exchange	
	Main Board	GEM*	A-Share	B-Share	A-Share	B-Share
No. of Listed Companies	1,938 H-Shares: 244	387 H-Shares: 24	1,455	51	2,133	48
Total Market Capitalization (bn)	HKD 33,194	HKD 167	RMB 30,432	RMB 86	RMB 19,467	RMB 61
Average P/E Ratio	11.56x	26.29x	14.11x	11.34x	23.67x	6.48x
Total Market Turnover	HKD 109,325 mn		RMB 265,024 mn		RMB 358,274 mn	

SOURCE: HKEx. As of February 22, 2019.

*GEM = Growth Enterprise Market.

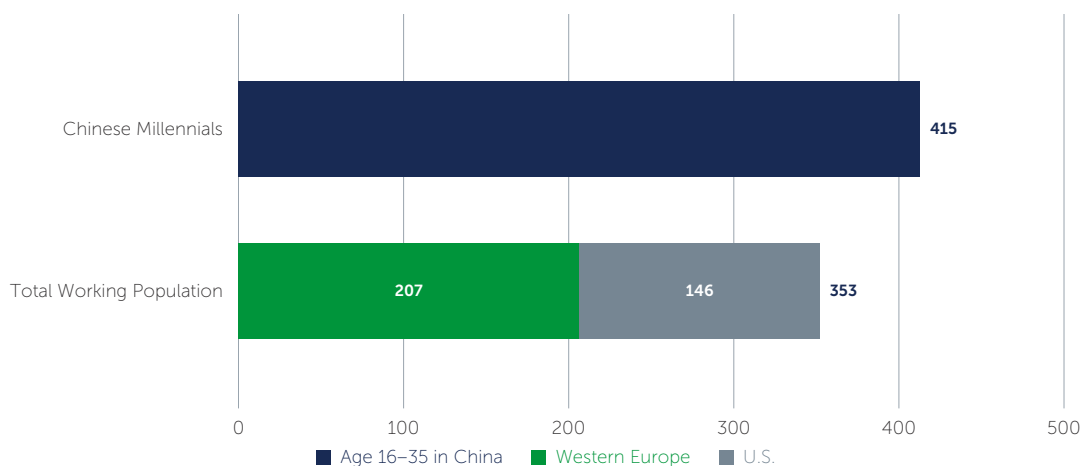
Barings' Investment View on Chinese Equities

Despite recent volatility on the macro front following trade tensions between China and the U.S., in addition to concern surrounding near-term domestic growth momentum, we remain constructive on Chinese equities over the long-term, driven by:

- **Positive and resilient earnings momentum:** Profit margins of Chinese companies have shown improvement after China's continued efforts to address overcapacity and inventory destocking, while producer price inflation increasing toward positive territory has generated pricing power and improved top-line growth. This should help drive a positive and sustainable earnings growth recovery over the long-term as these factors are largely non-cyclical in nature.
- **Attractive valuations:** Both onshore and offshore Chinese equities remain attractively valued both relative to their global peers and their respective historical levels, in our view.
- **Abundant policy ammunition to support growth:** China's monetary policy has become more accommodative, evidenced by the multiple cuts to banks' reserve requirement ratio, freeing up more capital for lending, while proactive fiscal policies such as the step-up in infrastructure investment and implementation of personal income tax reform should also bolster the long-term growth outlook.
- **Domestic factors become more dominant growth drivers:** Domestic consumption has increasingly become a significant contributor to China's real GDP growth. Favorable demographics, with the expansion of Chinese millennials supporting consumption, and the country's dedication to catching up on innovation/technology translate into sustainable growth catalysts.

From a bottom-up fundamental perspective, we are positive on companies that are well positioned to be the potential beneficiaries of continuing urbanization and consumption upgrades. As income growth continues alongside increasing demand for higher quality goods and services in China, we remain constructive on leading domestic consumption plays with strong brand and pricing power, as well as companies that manage to capture market share and benefit from industry consolidation.

FIGURE 3: China Has More Millennials Than the Working Population of the U.S. and Western Europe Combined (Population size in 2014, mn)



SOURCE: NBS, CEIC, Euromonitor, Goldman Sachs Global Investment Research. As of May 2016.

Focusing in particular on China A-shares, we hold a more constructive outlook for the asset class as improved liquidity and pro-growth policy direction provide support. The strong growth of China's domestic equity market, both in terms of market capitalization and breadth of listed companies, provides a ripe hunting ground for investors that are looking for fundamentally sound investment opportunities. We think that investors should not only keep a closer eye on China A-shares, but also position ahead and participate for the following three key reasons:

1. Lower correlation with global equity markets and other asset classes:

Due to the idiosyncratic nature of the China A-share market, it has historically been, and continues to exhibit, a lower correlation with other markets and thus provides investors portfolio diversification benefits.

FIGURE 4: 10-Year Correlation Among Different Markets and Asset Classes

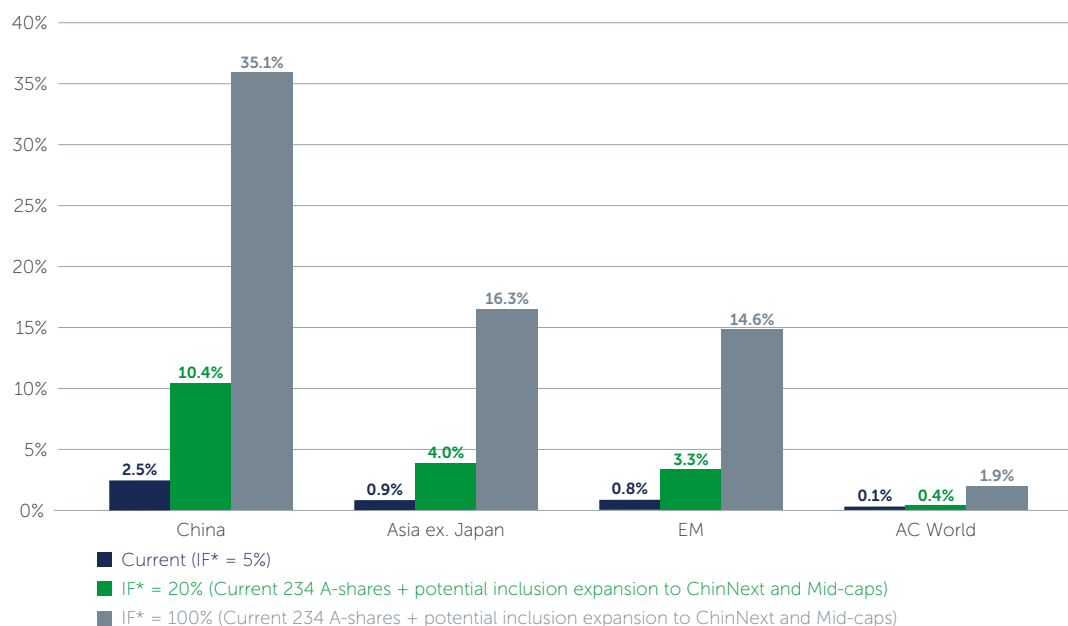
	China A-Share Equity	Asia ex. Japan Equity	U.S. Equity	Global Equity	EM Equity	Global HY	Global IG	EM HY	EM IG
China A-Share Equity	--	0.52	0.34	0.36	0.49	0.36	0.10	0.29	0.25
Asia ex. Japan Equity	0.52	--	0.75	0.82	0.98	0.79	0.51	0.70	0.66
U.S. Equity	0.34	0.75	--	0.97	0.76	0.67	0.34	0.52	0.46
Global Equity	0.36	0.82	0.97	--	0.84	0.77	0.44	0.63	0.54
EM Equity	0.49	0.98	0.76	0.84	--	0.81	0.55	0.75	0.69
Global HY	0.36	0.79	0.67	0.77	0.81	--	0.50	0.83	0.73
Global IG	0.10	0.51	0.34	0.44	0.55	0.50	--	0.53	0.71
EM HY	0.29	0.70	0.52	0.63	0.75	0.83	0.53	--	0.81
EM IG	0.25	0.66	0.46	0.54	0.69	0.73	0.71	0.81	--

SOURCE: Bloomberg. As of December 31, 2018.

Note: China A-Share Equity = MSCI China A Onshore Index; Asia ex. Japan Equity = MSCI AC Asia ex Japan Index; U.S. Equity = S&P 500 Index; Global Equity = MSCI World Index; EM Equity = MSCI Emerging Markets Index; Global High Yield = BoAML Global High Yield Index; Global IG = Bloomberg Barclays Global-Aggregate Total Return Index; EM HY = Bloomberg Barclays Emerging Markets High Yield Total Return Index; EM IG = Bloomberg Barclays Emerging Markets Investment Grade Total Return Index.

2. Further China A-share inclusion in global indexes: There are currently more than 200 China A-share large-cap names in the MSCI Emerging Markets Index following the decision for MSCI to include A-shares in its global indices for the first time in June 2018. As proposals for quadrupling the weighting of Chinese mainland shares (by increasing the inclusion factor from 5% to 20%), and expanding the inclusion universe to mid-caps and ChiNext stocks by November 2019 were approved on March 1, we believe that the trend of A-shares accounting for an incrementally bigger representation in the investible universe for global investors remains intact, and will serve as a structural catalyst for the onshore equity market as a whole.

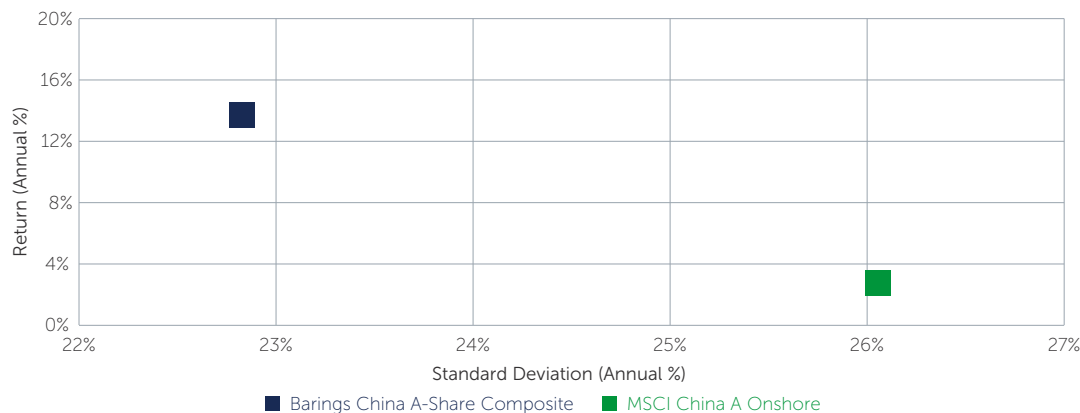
FIGURE 5: China A-Shares Weighting as a Percentage of MSCI Indexes



SOURCE: MSCI, FactSet, Goldman Sachs Global Investment Research. As of March 1, 2019.
*IF = Inclusion Factor.

3. **Market inefficiency means active investing, and NOT passive/beta-focus, is key to alpha generation:** High domestic retail investor participation and a low level of active sell-side coverage contribute to the inefficiency of the China A-share market, making bottom-up stock selection an optimal strategy for alpha generation, in our view. While over the past 5 years the China A-share market as measured by the MSCI China A Onshore index ended roughly flat, the Barings China A-Share Fund registered an absolute annualized gain of 13% in U.S. dollar terms (net of fees) at a lower level of volatility compared to the market (as of 31 January 2019). We believe this supports our view that an active, bottom-up investment process is fundamental in exploiting the inefficiencies in this relatively under-researched market.

FIGURE 6: Risk-reward for Barings China A-Share Composite (5 Years)



SOURCE: Source: Barings, MSCI. As of 31 January 2019. Risk-return performance of Composite results are calculated using a time-weighted total-rate-of-return formula, gross of fees.

Barings' Hong Kong China Equity Strategy Offerings

Barings has been managing dedicated Chinese equity portfolios for more than 35 years, and is at the forefront of investing in China A-Shares as access to this market continues to evolve. We have investment experience and operational capability to access onshore equity market via QFII, RQFII and Stock Connect. Barings is one of the front runners in offering access to the Chinese equity markets through its suite of Chinese equity strategies.

Barings Hong Kong China Strategy

(Equity: China: Core Composite)

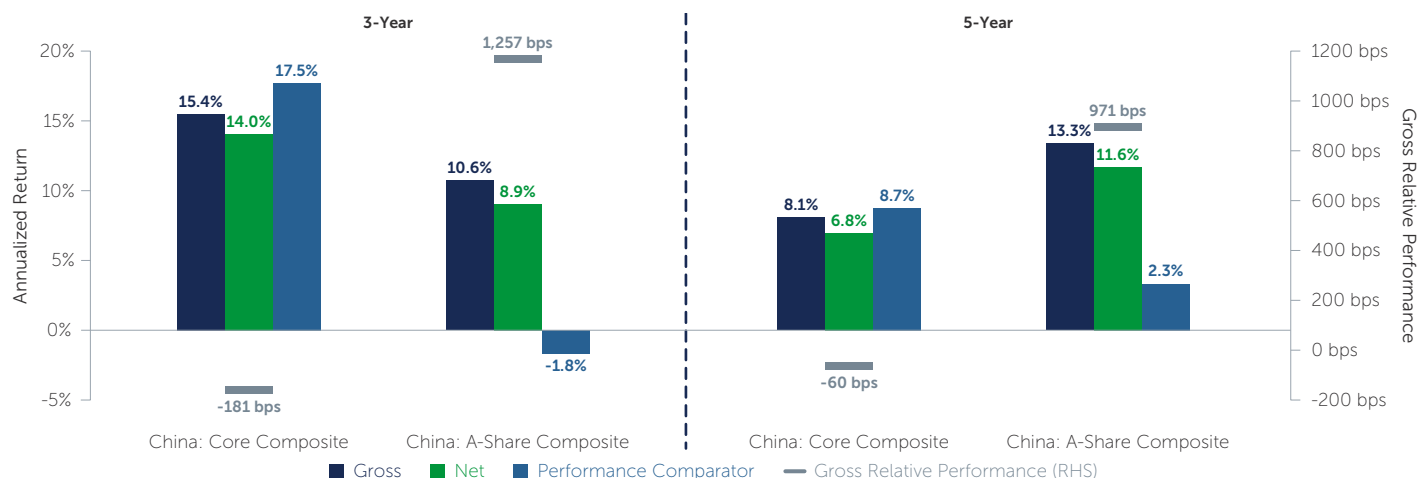
- Large scale all-caps Hong Kong China strategy
- Flexible investment universe and capability to capture the China growth story in a holistic approach by investing primarily in offshore-listed Chinese and Hong Kong companies, as well as Taiwanese and multi-national companies with significant exposure to China, with flexibility for limited exposure to the onshore Chinese equity market through Stock Connect
- Investment process tailored for asset class by a dedicated, large and experienced China equity team with 11 investment professionals based in Hong Kong, averaging 10 years of investment experience*
- Innovative methodology of integrating macro and dynamic ESG perspectives in valuation of equities and setting price targets

Barings China A-Share Strategy

(Equity: China: A-Share Composite)

- Flexible investment universe and capability to capture the China growth story in a holistic approach by investing primarily in onshore Chinese equities, with flexibility for limited exposure to the offshore Chinese equity market
- Investment process tailored for asset class by a dedicated, large and experienced China equity team with 11 investment professionals based in Hong Kong, averaging 10 years of investment experience*
- Innovative methodology of integrating macro and dynamic ESG perspectives in valuation of equities and setting price targets, which provides unparalleled edge for fundamental bottom-up analysis across the onshore Chinese equity market in which inefficiency is high and active sell-side coverage is low

FIGURE 7: Composite Historic Performance Using 3-Year and 5-Year Annualized Returns¹



SOURCE: Barings. As of January 31, 2019.

1. Composite results are calculated using a time-weighted total-rate-of-return formula. The composite s are asset-weighted; relative performance for each product versus its respective index is shown gross of fees. In order from left to right, the performance comparators used for the Composites above are: MSCI China 10/40 Index, MSCI China A Onshore Index, MSCI China 10/40 Index, MSCI China A Onshore Index; reference to the performance comparator index is for comparative purposes only.

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*Barings, as of 31 December 2018.

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