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China Insights

Does China deserve its own allocation?

Executive summary

Many Canadian investors have exceptionally low exposure to the investment opportunity presented by China. As the world's second largest economy, a decision to underweight China may be based on outdated perceptions. Long-term investors should re-examine their understanding of China and, in turn, consider revisiting their investment exposure.

We believe a key reason for this chronic under-appreciation stems from myths and misconceptions. Our goal is to focus on the evidence and share our insights to enable investors to make better-informed decisions.

Given the enormous opportunities presented by investing in China, ask yourself, in 10 years which question will you want to answer: "Why did I have exposure to China?" or "Why didn't I have greater exposure to China?"

Brent Joyce
Investment Strategist,
Mackenzie Investments

Chinese capital markets offer:

- Substantial size and trading volume
- Exposure to growth sectors, key thematic investments
- Diversification benefits
- Significant return potential

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Are Canadians ignoring China?

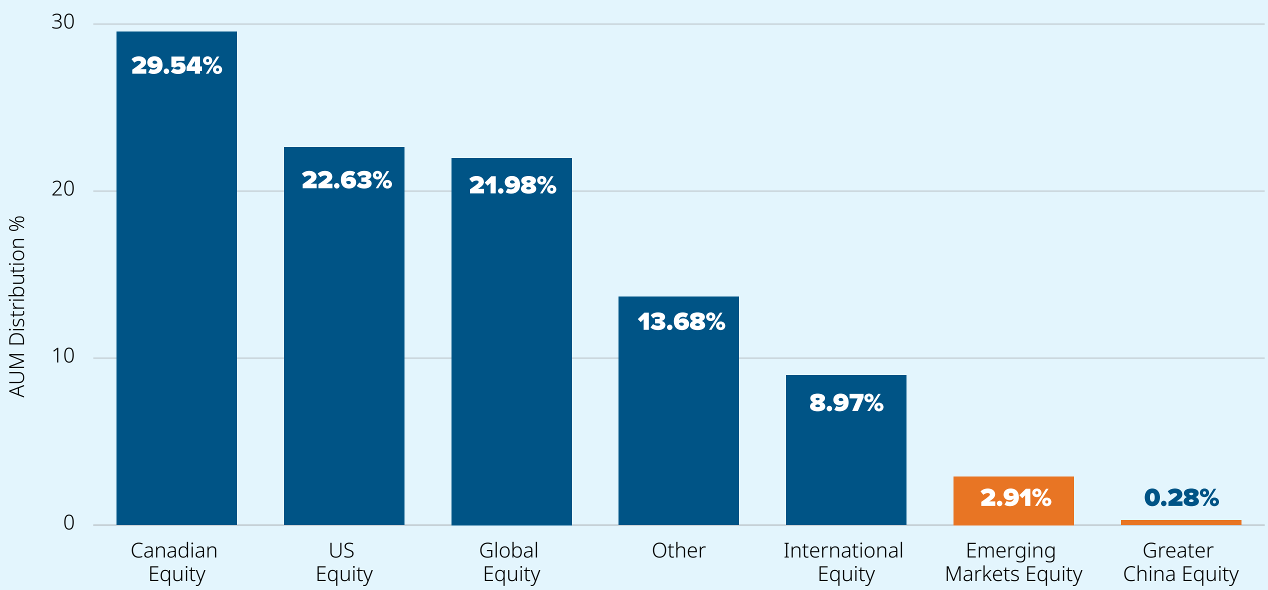
Great hockey players not only know where the puck is now but position themselves for where the puck is going.

With respect to the opportunity in China, our research suggests many Canadians aren't doing either – they're under-exposed based on the current opportunity and based on where the evidence suggests that opportunity is headed.

The Greater China Equity fund category (which includes both mutual funds and ETFs) represents just 0.28% of the total assets of pure equity funds in Canada – 0.28%!

The weighting of Chinese equities in the emerging market index is currently 41%, but dedicated Emerging Markets Equity exposure is only 2.9%. On this basis, Canadians still have a paltry 1.2% exposure to the opportunity in China.

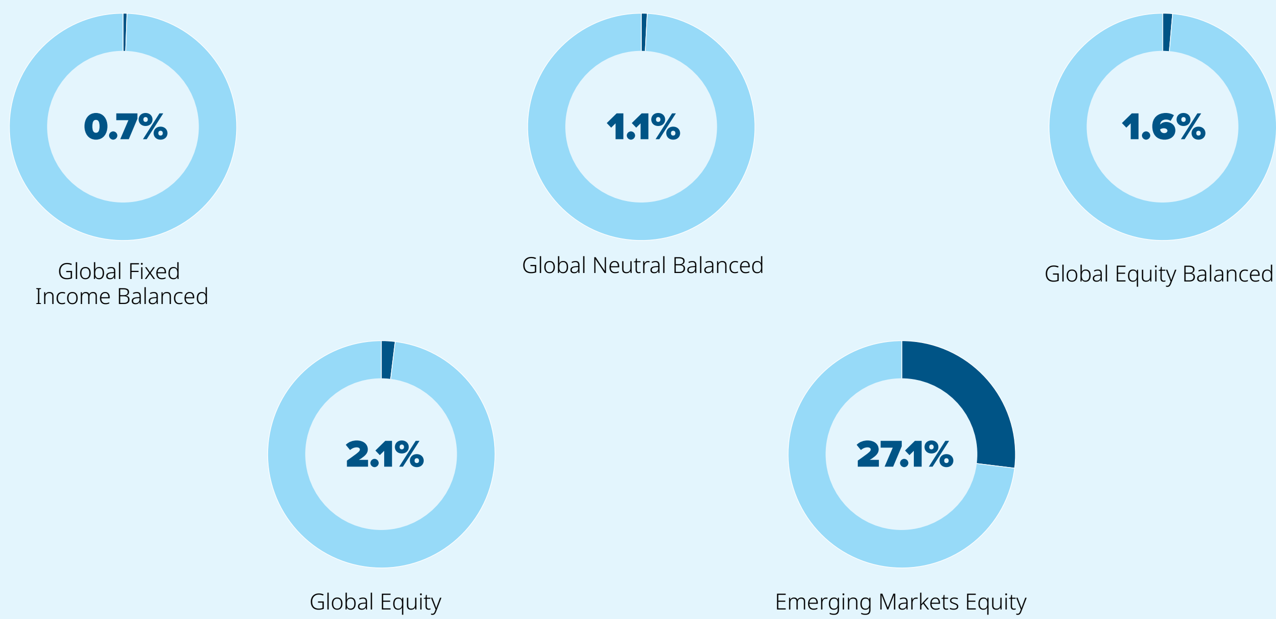
Table 1 | Canadians are under-exposed to China



Source: IFIC as of March 31, 2021

Canadian investors may believe that they are getting exposure to Chinese equities through their global equity or global balanced funds. But again, the reality tells us otherwise. Exposure to onshore China is between 1% and 2% in the broad balanced categories of Global Fixed Income Balanced, Global Neutral Balanced and Global Equity Balanced. And in the pure Global Equity category, the weight of onshore Chinese companies is a slim 2.1%.

Table 2 | Chinese equity exposure by fund category in Canada



Source: IFIC as of March 31, 2021

Canadian investors aren't alone in underweighting China. It is underrepresented in global benchmarks and under-owned by a broad swath of retail and institutional foreign investors.[1] We believe a key reason for this chronic under-appreciation stems from myths and misconceptions. Our goal is to focus on the evidence and share our insights to enable investors to make better-informed decisions.

We believe investors should take stock of their current exposure, and re-evaluate the pros and cons of allocating to China based on the return potential, risk-reward trade-offs and diversification benefits it offers.

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Improving opportunity and accessibility

Access to Chinese markets was closed to outsiders for many years. This is no longer the case. Initially, Chinese capital markets were opaque, illiquid and difficult for foreigners to access. To some extent there continue to be considerations around free-float market capitalizations, ownership restrictions, the maturity of the capital markets, accessibility constraints and regulatory restrictions. However, these are all changing rapidly.

A sea-change opportunity of this magnitude has presented itself in the past. China's opening of its capital markets is reminiscent of the market liberalizations undertaken in Europe and Japan in the 1980s and '90s.

China has had representation in the MSCI Emerging Markets Index (EM Index) as far back as 1997, with an initial weight at less than 1%. In just over a decade, China became the largest weight in the EM Index, surpassing 19% by 2009 and steadily growing until 2014.

That year marked an inflection point, as China's importance in emerging markets, indeed global markets, took off. Since then, several developments have given rise to China's EM index weight doubling from just under 20% to over 40% today.

There has been a deliberate effort on the part of China to modernize, diversify and liberalize its capital markets. There have been concerted efforts to improve regulatory frameworks, market microstructure, investor protection and information transparency/asymmetry. While there have been many small steps in this process, three significant events bear mentioning.

1 The Stock Connect system

This development marked the effective consolidation of the dual share structure between the onshore and offshore Chinese equity markets. In 2014, China initiated the Stock Connect system, which linked China's mainland stock markets in Shanghai and Shenzhen with the Hong Kong Stock Exchange. Stock Connect relaxed restrictions that historically split the Chinese stock market between shares available only to local investors (A-shares) and those available to international investors. Mainland Chinese investors can now purchase select Hong Kong and Chinese companies listed in Hong Kong, and foreigners can now buy China A-shares listed on mainland stock exchanges in a less restrictive manner.

The Stock Connect programs create a single Chinese stock market that ranks as one of the largest in the world by market cap and daily trading turnover.[2] For international investors, the programs add more than 1,400 companies to the investable universe. These moves help diversify the portfolios of Chinese investors, increase efficiencies for trading in dual-listed Chinese companies and increase the likelihood of Chinese shares being included in global benchmark stock indices.

2 Improved foreign access

The government has expanded and relaxed the Qualified Foreign Institutional Investor (QFII) and Renminbi QFII (RQFII) schemes, which have been in place for over a decade. Foreign investors in China now have a broader scope of investment choices, simpler application processes and reduced barriers to entry. The final aspect of these changes only took effect in November 2020 and they are being heralded as a game-changing move – one that looks set to fuel another surge in overseas demand for Chinese assets.

3 Increased index exposure

As a result of the above-noted changes and other reforms, global index providers have been increasing the weightings of Chinese assets in global equity and fixed income benchmarks. At stake is the inclusion of the onshore China A-share market, a market that, by design until lately, was challenging to access and mostly unfamiliar to global investors.

One of the most recognized index providers, MSCI uses an inclusion rate framework to determine Chinese A-share equity exposure in their benchmarks. The inclusion rate is currently set at an arbitrary 20% and, at the moment, there are no plans for it to increase. The low inclusion rate leads to a disconnect between benchmark allocations and the true economic significance of a stock market or a country's relative share of global economic activity. For context, under the 20% inclusion rate, the China weight in the MSCI Emerging Market Index is about 42%. If the inclusion factor were 50%, that weighting would grow to 47% and at 100% inclusion, the weight would become 52%.

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Too “good” to ignore

Measured in many ways, China’s importance on the global stage is expanding. It plays an important role in many of the world’s “megatrends” – those that will be the epicentre of innovation and investment opportunity for many years to come. Consider the “Made in China 2025” initiative, where China is striving to be a global leader in 10 key industries:

Advanced information technology (AI)

Automated machine tools and robotics

Aerospace and aeronautical equipment

Ocean engineering equipment and high-tech shipping

Modern rail transport equipment

Energy saving and new energy vehicles

Power equipment

New materials

Medicine and medical devices

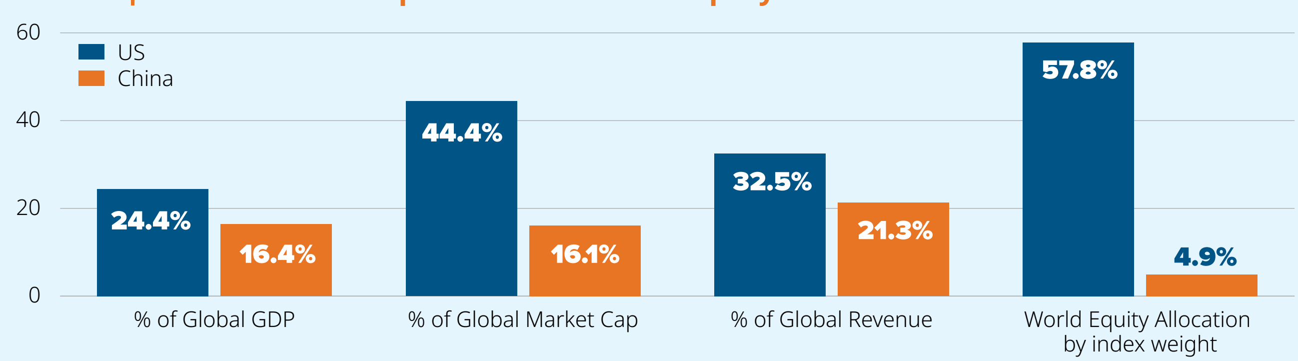
Agricultural equipment

China followed the rollout of the “Made in China 2025” program with the “China Standards 2035” initiative to revolutionize next-generation technologies. New standards will shape the playing field and landscape for the future of these technologies. China is striving to reach the next growth phase and drive high-value-added industries. We believe China will increasingly move beyond being a technological follower to become more of an innovator.

These initiatives may be aspirational, but they help to understand the future potential. China is one of the world’s most dynamic economies. At roughly two-thirds the size of the United States, as measured by GDP in US dollars,[3] China is the world’s second-largest economy. The April 2021 International Monetary Fund World Economic Outlook ranks China as the world’s largest economy[4] on a purchasing power parity (PPP) basis. On this basis, China comprised 18% of the world’s output in 2020, while the US is #2 at 16% and the euro area is #3 at 12%. In fact, China surpassed the United States on this measure in 2014.

But while China is 16.4% of world GDP, 16.1% of global market cap, 21.3% of global revenue, it is only 4.9% of world equity allocation by index weight!

Table 3 | China is under-represented in world equity allocation



Source: FactSet, as of March 31, 2021, in CAD. Revenue allocation is calculated by constituent’s annual sales in MSCI ACWI Index. World Equity Allocation is represented by member weights in MSCI AC World Index.

Ultimately, as investors, we should be focused on investment opportunities, not index weights.

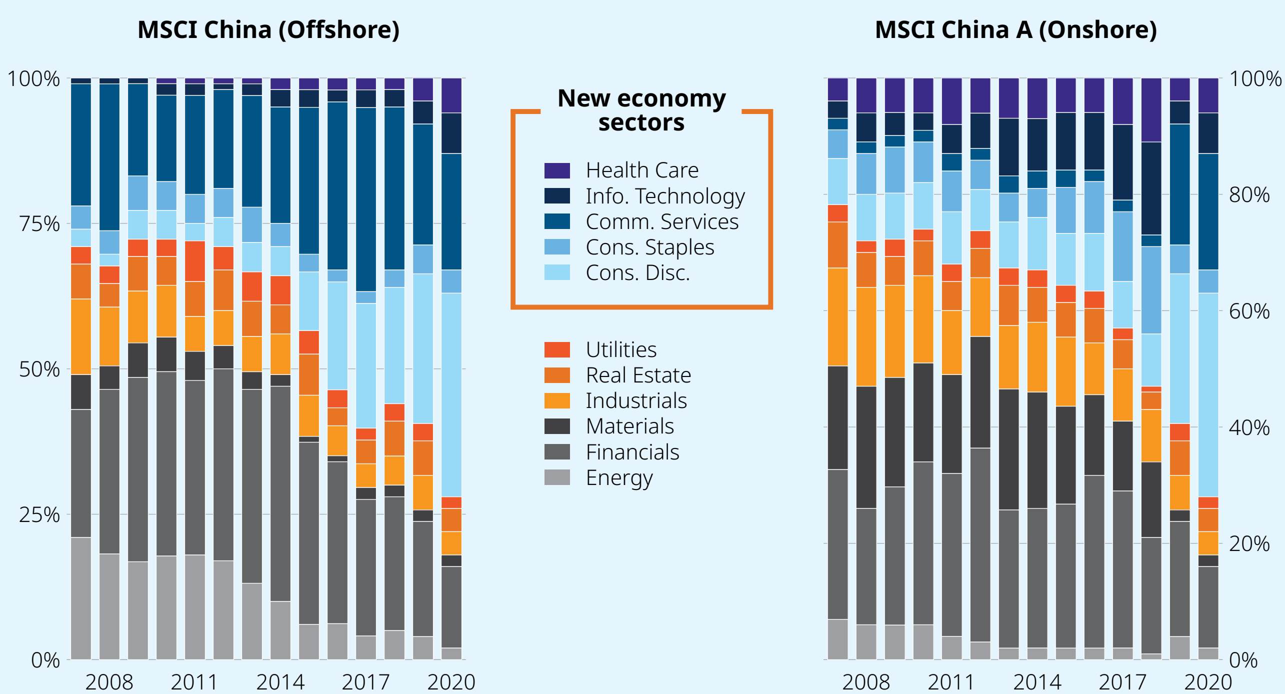
Capital market size and trading volume

Chinese markets offer ample scale and liquidity. The China A-share market ranks second overall behind the US by market capitalization. In US dollars, the combined Shanghai and Shenzhen China A-share markets are roughly US$10 trillion versus approximately US$35 trillion for the NYSE and NASDAQ combined.[5] Similarly, the average daily trading volume of the China A-share market is second only to the US. The average daily trading volume on the Shanghai and Shenzhen stock exchanges is over US$80 billion, whereas the NYSE and NASDAQ combine for over US$120 billion.[5]

Exposure to growth sectors, key thematic investments

The sector composition of Chinese equities has changed significantly over the past decade. High growth sectors, home to innovative new economy stocks, now dominate. Health care, information technology, communication services, consumer staples and consumer discretionary account for 73% of the offshore market and 53% of the A-share market.

Table 4 | Sector concentration over time - 'new' economy is growing rapidly



Source: FactSet, as of March 31, 2021.

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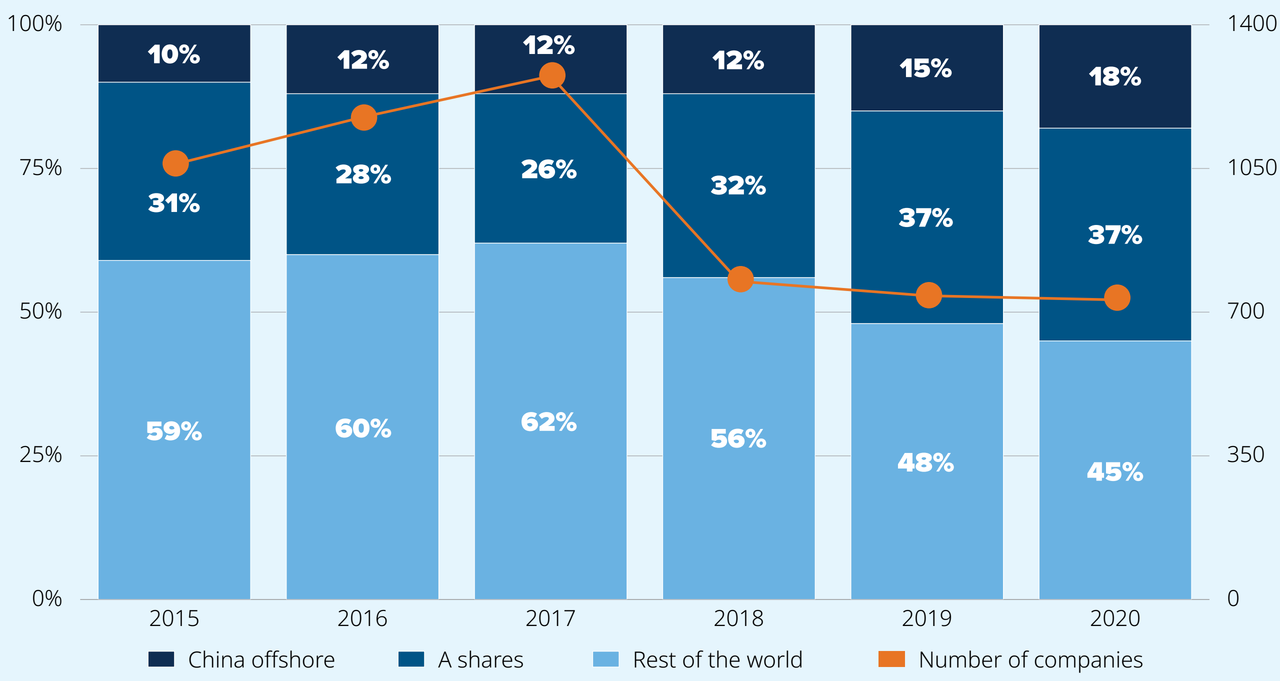
Investors looking for companies with high growth should consider investments in China, as it is home to the largest share of fast-growing companies in the world. In the MSCI All Country World Index universe, China boasts over half of the companies with sales growth greater than 10% – that's more than 700 companies.

Table 5 | % of companies with >10% trailing 3Y sales growth in MSCI AC World index

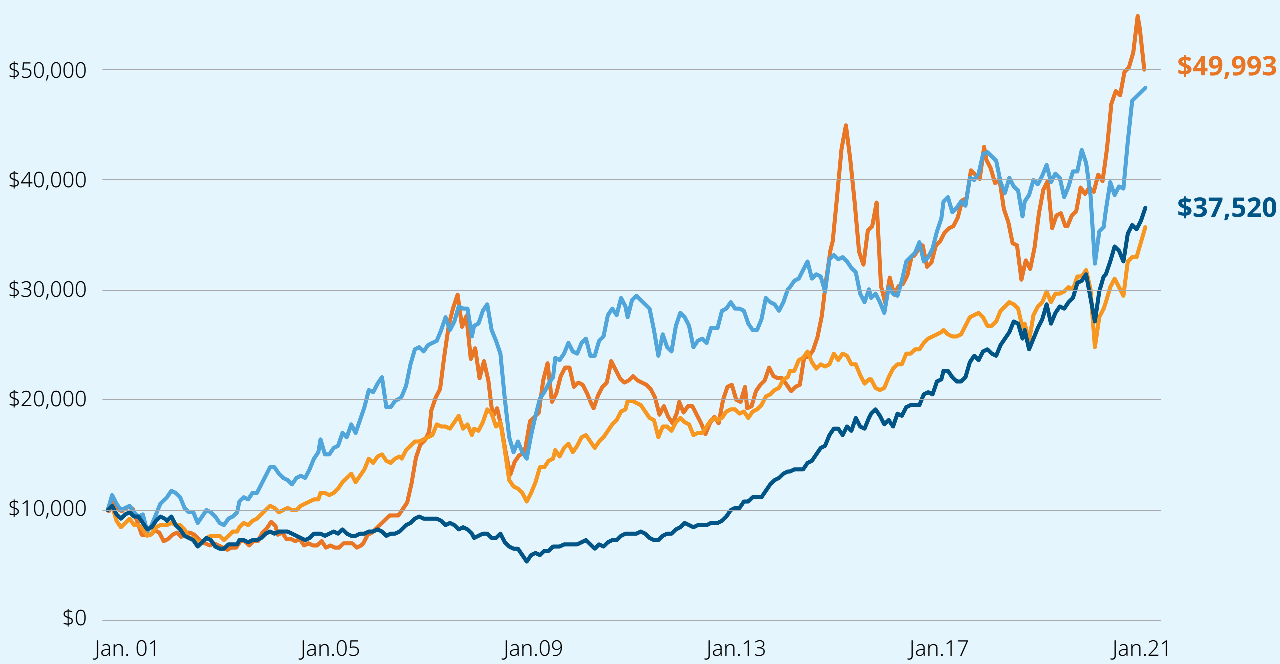


Source: MSCI, FactSet, Goldman Sachs Global Investment Research.

Return potential

The historical return from Chinese equities has been superior to many other equity markets. Given the tailwinds already discussed, we believe it will continue to deliver strong returns over the long term.

Table 6 | Significant market outperformance over the past 20 years



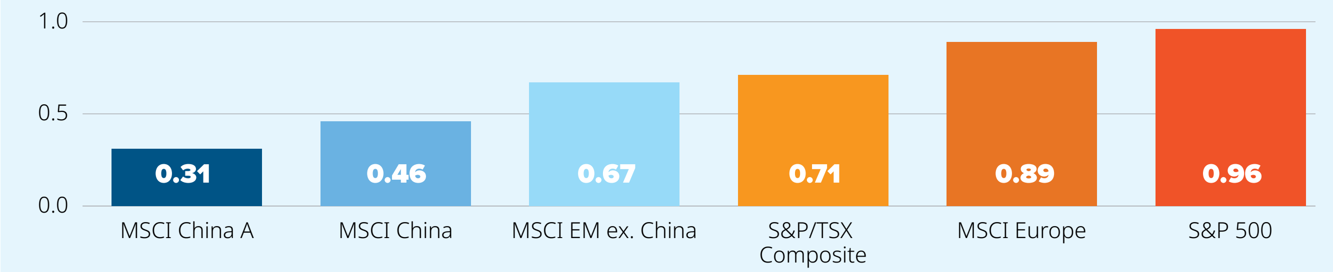
Market*	Compound annual growth rate	Cumulative return
All China Equity	8.30%	399.90%
EM Equity ex. China	8.10%	384.00%
US Equity	6.70%	275.20%
Canadian Equity	6.50%	257.30%

For Illustration Purposes Only.
Source: Morningstar Direct, January 01, 2001 - March 31, 2021. Currency: Canadian Dollar.
*All China Equity is represented by a Blended Benchmark - December 1, 2001 to May 30, 2008 is composed of 50% MSCI China A Index & 50% MSCI China Index; from June 1, 2008 to November 26, 2019 is composed of 100% MSCI All China Index, and MSCI China All Shares Index thereafter as MSCI transitioned the MSCI All China Indexes to the MSCI China All Shares Indexes as of the close November 26, 2019. EM Equity is represented by MSCI EM ex China TR Index; Canadian Equity is represented by S&P/TSX Composite TR Index; US Equity is represented by S&P 500 TR Index.

Diversification benefits

Chinese assets are potentially excellent diversifiers and may be a powerful ingredient to expand the optimal risk-reward position on the efficient frontier in portfolio construction. Good asset allocators know that assets with low correlations can be combined to create a whole that is better than the sum of its parts. Whether an asset comes with high or low volatility, it is useful from a portfolio optimization perspective if it has a low correlation with other assets in the portfolio.

Table 7 | Diversification – Chinese equities have low correlation with global equities

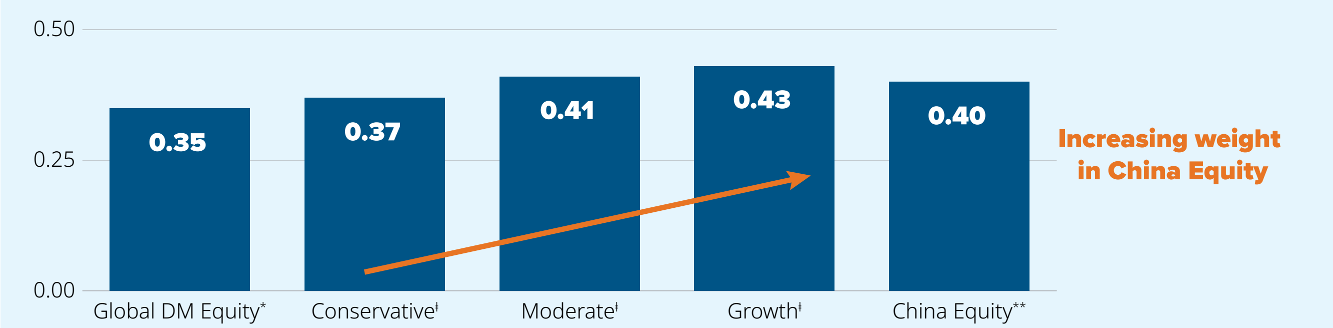


Source: Morningstar Direct, as of March 31, 2021, in CAD.

Historically, Chinese assets have come with high potential returns but also increased volatility. Importantly, Chinese equities have a low correlation with other traditional assets. Combining these characteristics of high return, high volatility and low correlation can potentially lead to lower expected risk and higher expected returns when Chinese assets are added in a meaningful way to portfolios.

Table 8 | Adding Chinese equities could enhance portfolio risk-rewards

Sharpe ratio improves, the higher the allocation to China Equity in a Global Equity portfolio.



Source: Morningstar Direct. January 1, 2001 – May 31, 2021, in CAD. *Global DM Equity is represented by MSCI World TR Index **China Equity is represented by a Blended Benchmark from December 1, 2001 to May 30, 2008 which is composed of 50% MSCI China A Index & 50% MSCI China Index; from June 1, 2008 to November 26, 2019 which is composed of 100% MSCI All China Index, and MSCI China All Shares Index thereafter. ǂConservative portfolio adds 5%, Moderate adds 15% and the Growth adds 25% of China Equity to the base Global Equity exposure.

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We believe China is a "must have" market

The opportunity in China isn't just "too big" to ignore; it is "too good" to ignore in our view. We believe Chinese equities offer compelling return, risk-reward, sector exposure and portfolio diversification benefits at portfolio weightings far in excess of current benchmark weightings.

At what point do we no longer consider China an emerging market? At what point do global investors begin to think of China along the lines of its economic and financial footprint in the world?

Whether that time is now or not is open to debate; however, we feel the answer to whether that time will ever come is unequivocal. There is considerable empirical evidence to support the argument that, as long-term investors, we should be looking at investments in China. Whether you choose to have dedicated exposure to China or access it through an emerging markets allocation, we believe that China is a "must have" market.

Visit mackenzieinvestments.com for more insights into the market from our experts.

1 "Crafting the optimal China allocation strategy, The asset owner's perspective" Greenwich Associates and Matthews Asia – Q2 2020.
2 "China: A shares in anatomy: 'A' primer for global investors," Goldman Sachs - October 28, 2020, data as of June 2020.
3 The World Bank 2019.
4 IMF World Economic Outlook April 2021, p. 126.
5 "China: A shares in anatomy: 'A' primer for global investors," Goldman Sachs - October 28, 2020, data as of June 2020.