MACKENZIE Investments

China: Your questions, our answers

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An on-the-ground view of China

Mackenzie's long-term partnership with ChinaAMC provides a unique opportunity to get an on-the-ground perspective of China, how its equity and bond markets have evolved, and what are the long-term drivers of growth for this dynamic economy.

Q | The history of China's capital markets is relatively short compared to its western counterparts. How developed are equity and bond markets in China?

I think that one of the easiest ways for foreigners to understand the development of China's capital markets is by talking about size. The US has the largest and most developed markets in the world, and for decades Japan held the number two spot. But Japan ceded that position, based on market capitalization and number of listed companies, to the China A-Shares market.

A key difference and advantage of China versus US markets is the ability to discover opportunities that are under researched, under invested and not well understood. Trading volume is dominated by retail investors, who tend to be more momentum and short-term driven. These two characteristics create a greater opportunity for alpha generation for a long-term, fundamental focused investor.

Chinese capital markets were once opaque, illiquid and difficult for foreigners to access until recently when the government started to implement strategies to make it easier to invest. The important steps were the creation of the Stock Connect system and relaxing the Qualified Foreign Institutional Investor (QFII) regimes.

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While foreign investors are getting more involved in Chinese equities, the Chinese bond market remains largely untouched. We believe this will change over time as inflows of about $1 trillion are expected by 2025.[1] In particular, Chinese Rate bonds, issued by the Treasury and three policy banks of China, offer attractive yield that is meaningfully higher than developed countries – around 150 to 200bps higher than US Treasury of similar tenor. As the interest rate cycle of China is not synchronized with the Fed or other developed countries, the Chinese Rate bonds also provide diversification benefits because of their low correlation.

Q | What does investing in China look like, in terms of sector weights and the size of companies?

I think it is important to point out that we invest across onshore and offshore listed Chinese companies, and there are differences in sector exposure between these markets. Onshore, financials dominate as most banks and insurers are listed there. Offshore, consumer sectors and communication services dominate as many internet companies chose to list in Hong Kong or New York. By investing across both onshore and offshore markets, we are able to access what we consider the best companies across the fullest opportunity set.

In terms of size, some of the largest companies in the world by size are Chinese. For example, the world's largest liquor company is not Diageo (owner of Johnnie Walker whiskey, Smirnoff Vodka, and Guinness) or Heineken. In fact, Kweichow Moutai, a Chinese liquor company, is almost four times the market cap of Diageo![2]

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Q | Is there an advantage to active management in China?

China equity beta is not exceptional compared to the US – historically, it has been around 6-10% per annum, which isn't dissimilar to the S&P 500.[3] However, it is the potential to generate alpha from market inefficiencies that excites us. Anecdotally, around 30% of global equity managers outperform in any given three-year period[4], net of fees. In China, that figure is as high as 70%.[5]

In addition, we think that while the Chinese onshore stock market is a significant and important part, it is nevertheless only a subset of the full China opportunity set, which includes Chinese companies listed on the Hong Kong stock market and in the US via ADR (American Depositary Receipts). Hence, we think the "all China" strategy, where investors have access to what we see as the best Chinese companies, is the most suitable approach.

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Q | What do you think are the greatest challenges to investing in China?

Short-termism

The case for investing in China is backed by long-term, secular trends with three- to five-year time horizons. As the financial market in China matures and opens further, we believe its volatility will reduce. However, as retail participation is currently high and because of the various inefficiencies mentioned previously, the short-term volatility of China equity market is higher than developed equity markets. Therefore, we think short-termism presents a real danger to investors as they could suffer from a whip-saw effect, where the market can make significant gains and losses within a very short period making market timing very difficult, so short-termism could be detrimental to investors unfamiliar with the market. We encourage any investor in China's markets to take a long-term view.

Headline news

Since 2018 there has been a continued escalation of the trade war, and the US has enacted a number of policies targeted at the Chinese government and Chinese companies.

Such headline news often leads to short-term market volatility, although over the long run it has had limited impact on asset values. This is an area of risk that anyone investing in China should be aware of, and another reason why partnering with a fundamental, long-term stock picker like ChinaAMC, whose expertise and on-the-ground knowledge allows us to make more informed investment decisions.

Q | What do you think are the most exciting investment opportunities in China?

There are four long-term trends that we believe will continue to shape the Chinese economy for the next five to 10 years. First, is what we call the "consumption upgrade." Despite its economic might, China does not have a single global brand as well-known as Coca-Cola or Nike that exports globally. However, Chinese consumers are already the largest customer group for luxury products globally. As China looks to internalize some of this consumption, we think this leads to exciting growth opportunities for local brands and local distribution partners.

Another key trend is advanced manufacturing and export of high value-add goods. China is a world leader in producing science, technology, engineering and math (STEM) graduates.[6] The accumulation of a large cohort of highly-educated workers has fostered a significant edge in advanced manufacturing in fields such as medical equipment, biotech and drug development.

China is a leader in technology and boasts an internet-enabled economy – it already has the world's largest e-commerce market by value[7] and the second highest number of internet unicorns (start-up companies valued at more than US$1 billion).[8] With a fast-growing economy, vast supply of well-educated workforce and excellent infrastructure, we believe China's e-commerce and internet economy could be a breeding ground for world-leading companies.

The fourth key long-term trend is carbon neutrality and renewable energy. China accounts for more than 70% of global production capacity of solar panels[9] and is home to more than 50% of the world's battery electric vehicles.[10] In our opinion, Chinese companies are likely to continue leading and will help many countries transition towards carbon neutrality and a more sustainable future. As the largest carbon emitter in the world, China is also committed to making the transition with specific targets announced, including reaching "peak carbon" by 2030 and carbon neutrality by 2060. We believe China will likely make significant contributions to help achieving the goals of the Paris Agreement.

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1 Source: Goldman Sachs
2 Source: Yahoo Finance
3 Source: Morningstar Direct
4 Source: eVestment
5 Source: Morningstar
6 National Science Board (US), Science & Engineering Indicators, 2018.
7 J.P. Morgan 2020 E-commerce Payments Trends Report.
8 Source: CB Insights
9 Statista, Regional distribution of solar module production, February 2, 2021
10 International Energy Agency, Global EV Outlook 2020

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