PUBLIC EQUITIES

China: The Great Disconnect

BARINGS INSIGHTS

William Fong, CFA
Head of Hong Kong China Equities

Robert Li
Director, Client Portfolio Manager, Equities

Chinese equities offer many unique attributes, particularly given the improving access to the onshore market, which offers investors direct exposure to China's economy as it repositions itself for long-term sustainable growth.

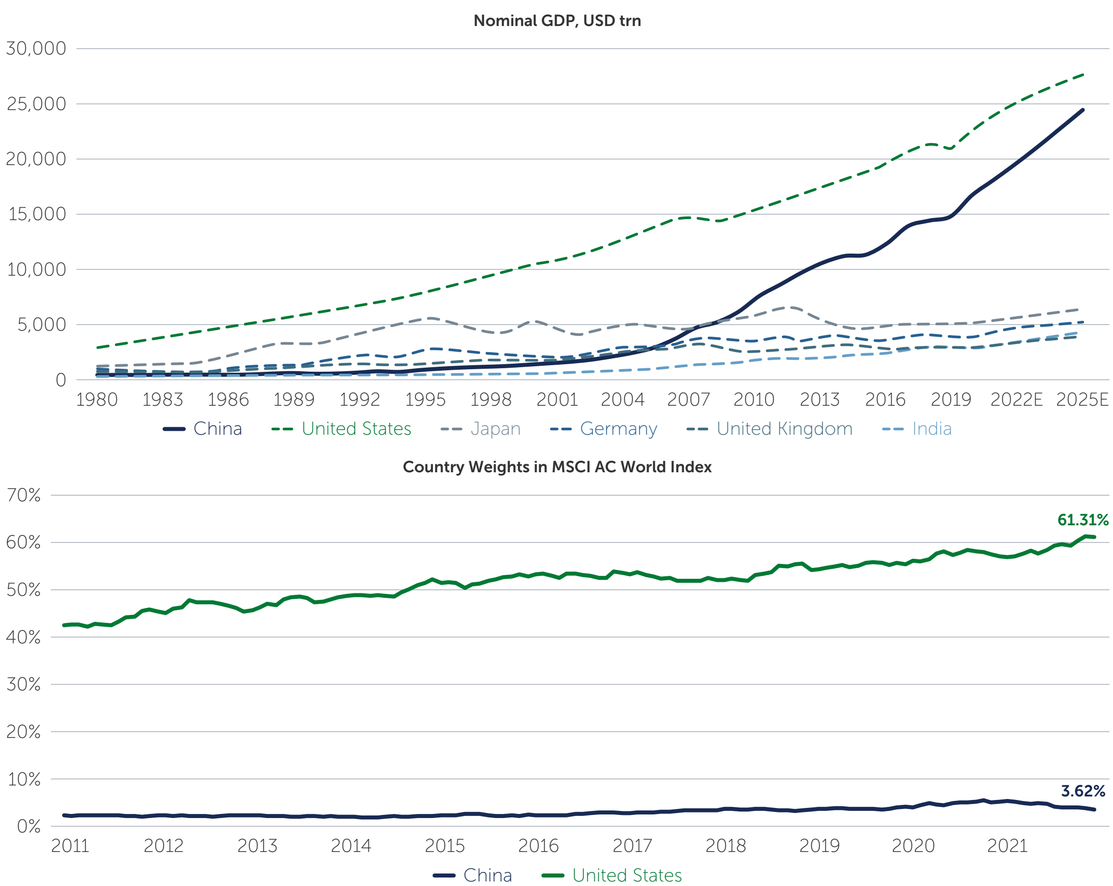
It is safe to say that China has been in the spotlight lately, whether due to the country's extensive regulatory crackdowns or ongoing trade and political tensions. As a result, many investors have been reviewing their exposures to the country and its companies. While uncertainties remain on the horizon, we believe the current regulatory cycle—which aims at providing oversight for long-term sustainable development—may be approaching an end. Moreover, from an investment standpoint, Chinese equity valuations appear relatively attractive compared to other key global markets, suggesting the current environment may provide a compelling entry point.

The Great Disconnect

China has made tremendous progress integrating itself into the global economy since announcing its Open Door Policy in 1978. China's nominal GDP grew by 37x from 1960 to 2020, surpassing India, the U.K., Germany and Japan in the process.[1] At the same time, the country leveraged its demographic dividend and the growth of its working-age population—amid a total population of nearly 1.4 billion people—and emerged as a middle-income economy. By 2020, the Chinese economy had grown to $14.7 trillion, which represents 17.4% of global GDP, making it the second-largest economy in the world.[2] China is also the largest trading partner for many countries, and has cemented itself as a key part of the global supply chain.

Despite the size and growth of its economy, China is often overlooked by international investors and underrepresented relative to other global equity markets. In fact, China's representation in MSCI's global equity index is in the low single digits **(Figure 1)**.

Figure 1: China: A Mismatch in Allocations



Sources: IMF World Economic Outlook; MSCI; FactSet; Barings. As of December 31, 2021.

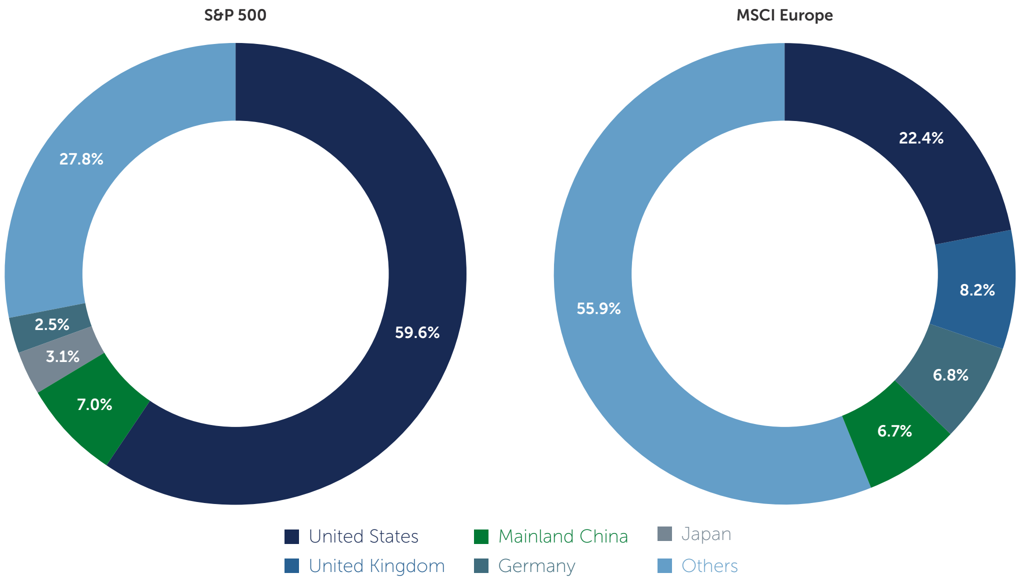
1. Source: World Bank. As of July 31, 2021.
2. Source: World Bank. As of July 31, 2021.

"Global investors gaining exposure to China via developed market indexes likely remain underweight to the key structural growth drivers shaping opportunities in the asset class."

An Underrepresented Asset Class

Some may argue that investments in multinational corporations—such as global leaders in consumer-packaged goods, automotive, raw materials and technology—can provide exposure to China's economic growth. While that may be true to an extent, a closer look at the revenue breakdowns of such companies reveals that many have lower levels of direct exposure to China, resulting in an effective underrepresentation of the country's true economic standing across major developed market indexes. For example, only one of the FAANG[3] companies has a meaningful footprint in mainland China. China makes up 10.0% of the revenues generated by companies in the MSCI AC World index, and an even lower 7.0% share in the S&P 500 index.[4] This means global investors gaining exposure to China via developed market indexes likely remain underweight to the key structural growth drivers shaping opportunities in the asset class.

Figure 2: Under-Representation of Revenues From China



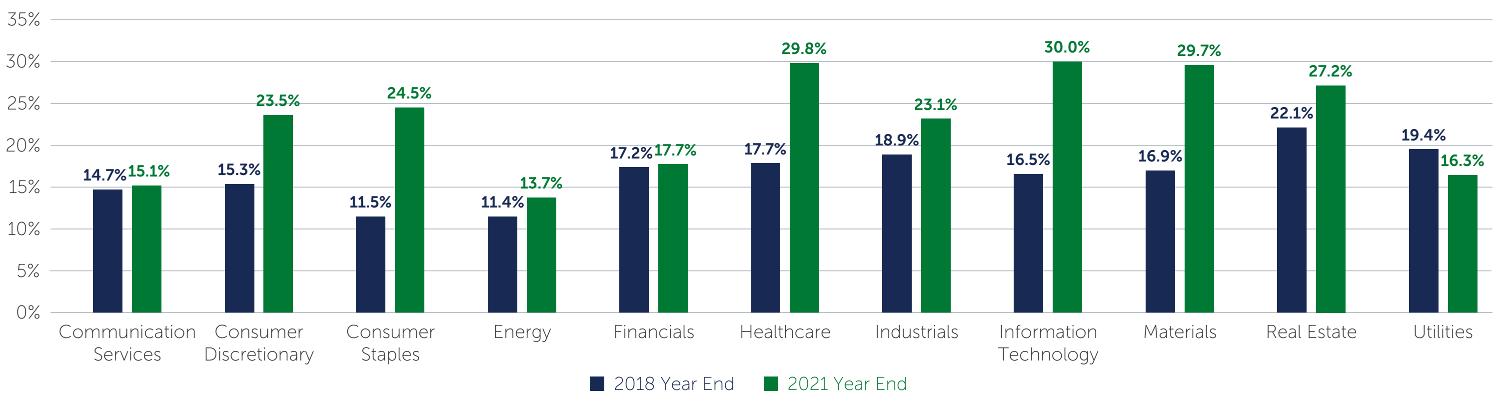
Sources: FactSet; Barings. As of December 31, 2021.

3. Meta (formerly known as Facebook), Amazon, Apple, Netflix and Alphabet (formerly known as Google).
4. Sources: FactSet; MSCI; Bloomberg; Shanghai Stock Exchange. As of December 31, 2021.

Further, global companies have been slower to capture trends, such as a shift in Chinese consumer preference toward local brands. As Chinese consumers' quality of life continues to improve, the attractiveness of western products seems to have somewhat diminished, with many consumers preferring products that are more convenient for, and tied to, the Chinese lifestyle. At the same time, the global profile of Chinese companies has been rising. For example, the number of Chinese companies within various sectors of the MSCI All Country World Index grew by 8.3% on average between 2018 and 2021 **(Figure 3)**.

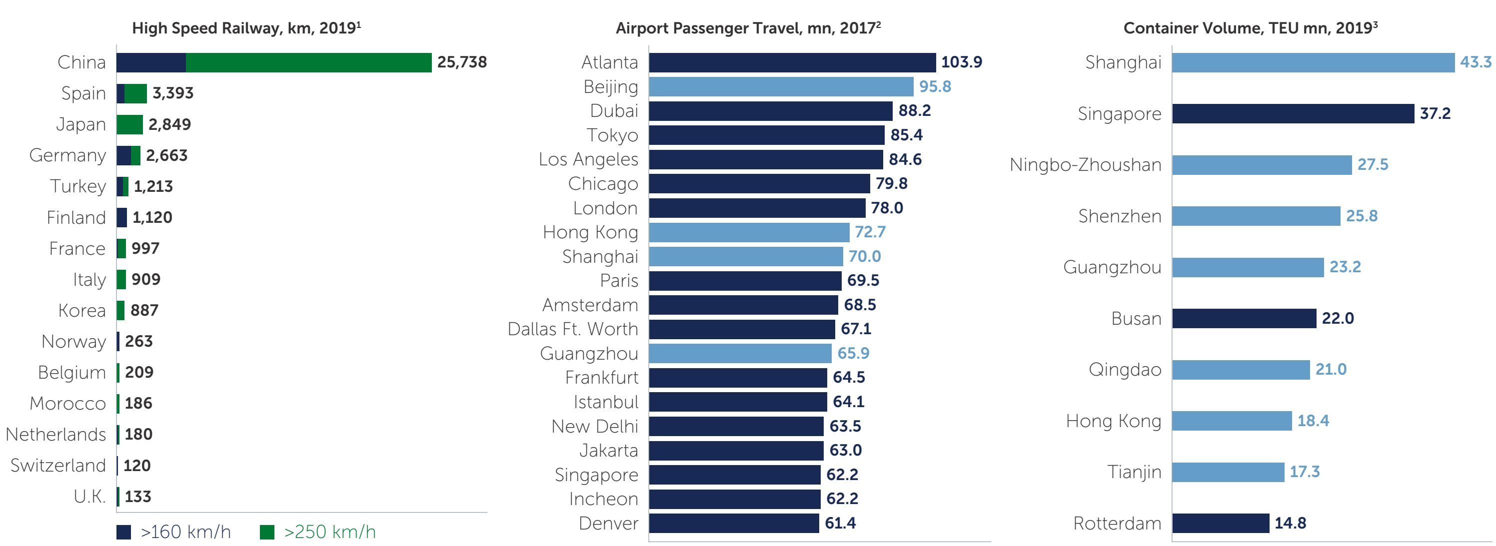
In a number of these sectors, Chinese companies are among the largest in the world. Over the years, China has heavily invested in its own infrastructure in order to support its supply chains and strengthen its long-term economic prospects. As a result, the country's high-speed railway system, airports and container ports, for instance, are some of the largest and busiest in the world today **(Figure 4)**. In addition, China is set to have leading 5G infrastructure in place. In our view, this combination of physical supply and technological connectivity provides an innovative and stable web of infrastructure that will drive the continued commercialization of China—and grow its dominance in emerging technologies such as electronic vehicles, semiconductors and augmented/virtual reality.

Figure 3: Percentage of Chinese Companies Across Sectors in MSCI AC World Index by Number



Sources: FactSet; Barings. As of December 31, 2021.

Figure 4: China's High-Speed Railway System, Airports and Container Ports are Some of the Largest and Busiest in the World Today



1. Source: UIC—International Union of Railways. As of July 31, 2021.
2. Source: Airports Council International. As of July 31, 2021.
3. Source: Lloyd's List One Hundred Ports 2021.

The "A" in China Equities

Chinese companies may be listed on exchanges outside of mainland China ("offshore")—such as Hong Kong and the United States—and within mainland China ("onshore"), such as the Shanghai Stock Exchange and the Shenzhen Stock Exchange. The onshore equity market is commonly referred to as the "China A-shares" market. While most global investors invest in Chinese companies through their offshore listings, a significant number of investment opportunities are only uniquely available in the A-shares market.

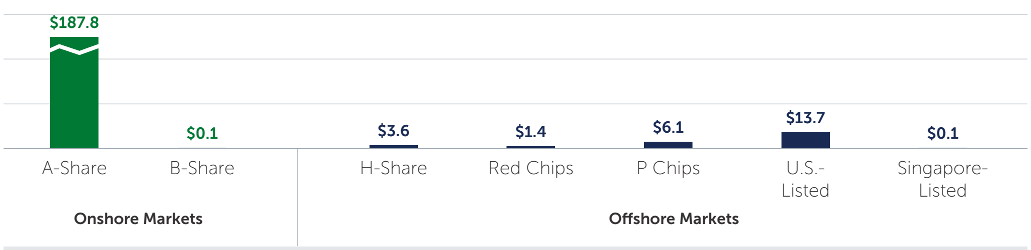
Looking at the constituents of MSCI China All Shares index, which captures large and mid-cap companies across both onshore and offshore listings, 42.8% of the companies by index weight only have listings in the China A-shares market—including strong performers across the tech, health care and consumer sectors.[5] In order to uncover the hidden gems across the China A-shares market, however, additional expertise is required to overcome barriers including language, culture, and regulatory environment.

BENEFITS OF A-SHARES

In addition to the unique sector and company exposures, the China A-shares market offers a number of other key benefits, including:

- **Greater Liquidity**
  A unique aspect of China's A-shares market is the participation of its sizable population. More investors translates into a hugely liquid market, dwarfing that of its offshore-listed counterparts. For instance, the six-month average daily trading volume of the China A-Shares market was nearly $187.8 billion as of the end of August, versus roughly $24.9 billion for China's offshore markets **(Figure 5)**.

Figure 5: 6-Month Average Daily Trading Volumes of Onshore vs. Offshore Markets (US$ bn)



A-Shares: Chinese companies listed on the domestic stock exchanges, trading denominated in RMB.

H-Shares: Chinese companies listed on the Hong Kong stock exchange.

Red Chips: Companies incorporated outside of mainland China by are controlled by mainland government entities.

P Chips: Hong Kong Companies listed on the Hong Kong stock exchange.

U.S.-Listed: Chinese companies listed on the U.S. stock exchanges.

Singapore-Listed: Chinese companies listed on the Singapore stock exchange.

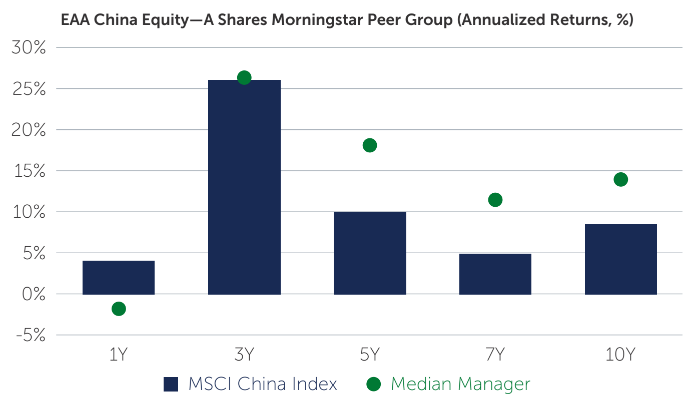
Sources: Bloomberg; Factset; Wind; Goldman Sachs Global Investment Research. As of December 2021. Note: Onshore Chinese stocks include A-Shares and B-Shares. All offshore Chinese stocks are listed in the Hong Kong, U.S. and Singapore stock exchange only.

5. Sources: FactSet; MSCI; Bloomberg; Shanghai Stock Exchange. As of December 31, 2021.

- **Less Efficient**
  There is a higher level of retail investor participation in the China A-shares market, meaning investment sophistication can vary widely. This creates inefficiencies, which in turn can present attractive opportunities for professional active managers to generate alpha—particularly when using a bottom-up, research-driven approach to identify long-term opportunities.

  For example, the median active manager was able to outperform the benchmark by 802 basis points (bps) annualized over a 5-year horizon, and 549 bps annualized over a 10-year horizon. **(Figure 6)**.

Figure 6: Active Managers Can Generate Additional Alpha in Chinese Equities

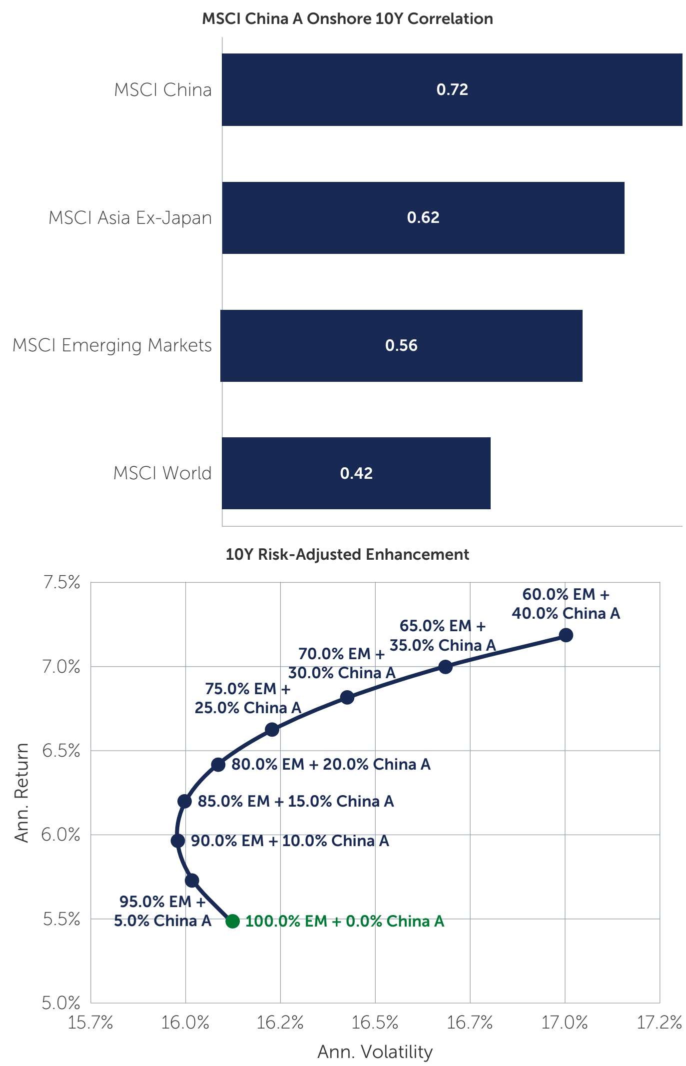


Source: Morningstar. As of December 31, 2021.
Based on Morningstar Category - EAA China Equity - A Shares and currency hedged = NA.

- **Low Correlation with Other Markets, and the Opportunity to Enhance Risk-adjusted Returns**
  The China A-shares market has historically exhibited low correlation with global equity markets, for a number of reasons—from the unique representation of companies, macroeconomic environments, policy cycles and investor profiles, to the accessibility of the market. As a result, having exposure to Chinese A-shares not only has the potential to generate excess returns, but also provides an opportunity to enjoy diversification benefits.

For instance, when looking at historical data of the respective market over the last 10 years, adding approximately 15% of China A-shares to an EM allocation could have reduced volatility and enhanced returns. It is worth noting that the amount of additional allocation is consistent with the pro-forma weight of China A-shares, assuming a 100% inclusion factor.

Figure 7: China A-Shares Offer an Opportunity to Enhance Risk-Adjusted Returns

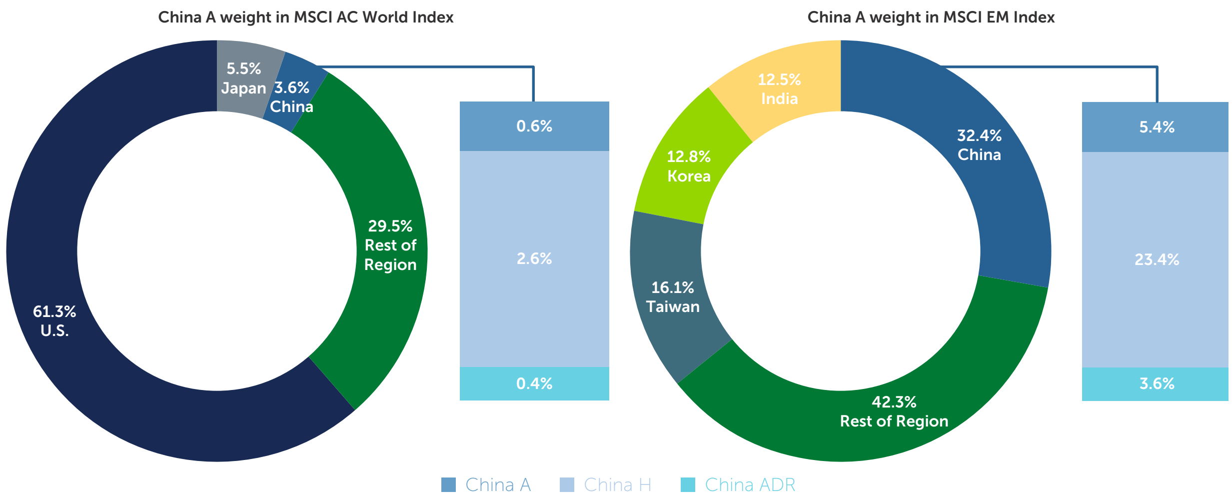


Sources: FactSet; Barings. As of December 31, 2021. Correlation calculated using monthly return of respective indexes, calculated in USD. EM is MSCI Emerging Markets Index and China A is MSCI China A Onshore Index, calculated in USD.

Gradually Improving Access

Despite the unique properties of the market, China A-shares have only recently come into consideration for many global investors. In May 2018, MSCI began its inclusion of the China A-shares market into its global indexes. As of December 2021, an inclusion factor of 20% of large-cap and mid-cap A-share companies came into effect. Essentially, this means that China A-share equities are only included at a fraction of their market capitalization, resulting in an even lower exposure to A-shares across standard equity benchmarks.

Figure 8: Inclusion Factor Reduction Means Even Lower Exposure to China A Shares



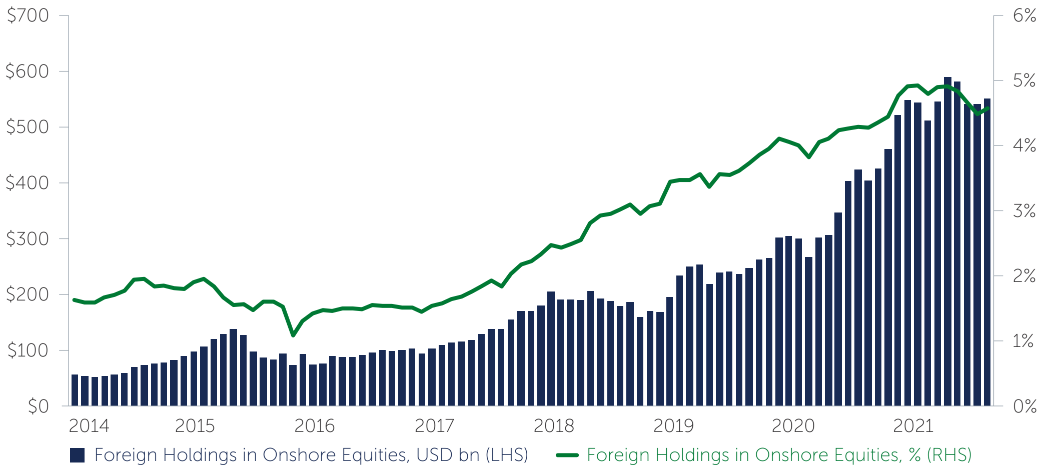
Sources: FactSet; Barings. As of December 31, 2021.

In order to improve the accessibility of the A-shares market to global investors, Chinese regulators have launched a number of initiatives over the years. This began with two "quota systems," known as Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) schemes, which were launched in 2002 and 2011, respectively. The schemes have since been simplified in order to improve liquidity and ease of access. More recently, access to the A-share market was enhanced by the introduction of what is known as the Stock Connect programs—the Shanghai Stock Connect and the Shenzhen Stock Connect—which were launched in November 2014 and December 2016, respectively. These programs further allow global investors to access eligible A-share companies by enabling trading on the two mainland stock exchanges, while clearing trades through the Hong Kong Securities Clearing Company (HKSCC), increasing international connectivity.

The introduction and gradual liberalization of these access channels for China A-shares has gradually increased foreign investors' representation. In fact, foreign investors hold approximately $552 billion in China A-shares, or 4.6% of the overall market—a tenfold increase from just over $50 billion, or 2%, in January 2014 **(Figure 9)**.[6] Although the path for further inclusion beyond the current factor is yet to be announced, we believe the gradual and eventual inclusion of China A-shares—as well as increasing participation from long-term, global investors—will be another source of support for onshore asset prices, and may also help lower market volatility over time.

6. Sources: Bloomberg; Barings. As of December 31, 2021.

Figure 9: Rising Representation of Global Investors Supported by Improved Access



Sources: Bloomberg; Barings. As of December 31, 2021.

Key Takeaway

Various aspects of the Chinese economy have been, and will likely continue to be, a topic of discussion in the years to come. Practical analyses indicate that global investors are likely under-allocated to Chinese equities relative to the country's global economic standing.

In its most recent Five-Year Plan, the socio-economic blueprint, the Chinese government stated its intention to develop a circular economy, enhance environmental sustainability, and double its GDP per capita by 2035—while China's recent pledge to achieve carbon neutrality and improve ESG standards is indicative of the country's growing responsibility in the fight against climate change. The subsequent consumption rebalancing, green infrastructure development and technological advancement will undoubtedly introduce a variety of exciting, long-term investment opportunities, which can only be accessed through Chinese companies.

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