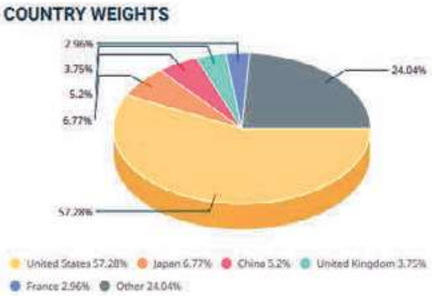
Opportunities in China

Should UK pension schemes have higher equity allocations to China?

The Chinese economy has grown at an impressive rate in recent decades to become the second-largest in the world as measured by GDP, second only to the US and around three times the size of the world's third largest economy, Japan. Recent studies suggest that the Chinese economy will overtake the US before the end of this decade. Yet Chinese companies represented only 5.2% of the MSCI ACWI Index as at 31 December 2020 (source and chart below: MSCI).



Many schemes invest in passive developed market equity funds that allocate on a fixed weight basis with a UK bias. As China is still categorised as an emerging market (EM), some schemes will therefore have zero allocations to the world's second largest economy.

It is worth bearing in mind that economic heft is, rightly, not the only criterion for including and then weighting a country's companies in an equity market index, or for sizing pension scheme equity market allocations. A key argument for classifying China as an emerging market is its GDP per capita, which remains comparable to those of other emerging economies, and lower than those of countries in developed market equity indices.

How do investors gain access?

Historically only mainland Chinese citizens could buy China A-Shares (the local currency denominated shares of mainland Chinese companies), though this restriction was relaxed initially in 2003, and tellingly in 2014 and 2016 via the stock connect programmes that linked the mainland Chinese exchanges to Hong Kong.

Other ways to access listed Chinese companies are via B-Shares (listed in mainland China and denominated in Hong Kong Dollars or US Dollars) and H-Shares (listed in Hong Kong and denominated in Hong Kong Dollars). Investors can also get exposure to Chinese companies and the Chinese economy via Red-Chips, P-Chips (listed in Hong Kong) and N-Chips (listed in the US).

The allocation to A-Shares in emerging market indices has been increased on a phased basis, to the point where some investors are now concerned about the concentration of emerging market indices to China. Some make the case, which I believe has merit, that as a singularly large emerging market that has its own unique features compared to other emerging markets, China should be considered as a standalone equity market.

What are the risks?

Investors in emerging markets always bear a certain degree of political and currency risk in exchange for higher expected returns. When investing in China A-Shares, investors should also be mindful of ESG considerations, geopolitical risk (Sino-US trade tensions have been a feature of the global economic landscape for a while now), and the possibility of state intervention.

As retail investors account for over 80% of the daily trading volume, the market can be more volatile than other emerging markets.

Where do pension schemes go from here?

The Chinese economy continues to grow at a quicker pace than the US and other developed market economies and continues to close the GDP per capita gap. As A-Shares now make up a greater proportion of emerging market equity indices, more money will be invested in these companies.

The flow of capital into Chinese assets is also likely to accelerate as China continues to open its markets to foreign capital (limits on foreign ownership of Chinese companies remain in place), assumes greater importance as a financial centre, and a greater proportion of global financial transactions are traded in Chinese Renminbi. It also seems that many fund managers are only now beginning to take more interest in China, suggesting that the flow of capital will increase further as more institutional money is invested.

Given GDP growth, GDP per capita growth, increased weightings within EM equity indices, improved market access for foreign investors, its greater importance as a financial centre and more Renminbi denominated trade, it makes sense for DB pension schemes to consider increasing their allocations to Chinese equities.

I believe that the best way for many schemes to access Chinese equities is via broad, actively managed funds that enable skilled investors to select the best companies from a global or EM opportunity set, such as unconstrained active global equity funds and/or emerging market multi-asset funds.

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