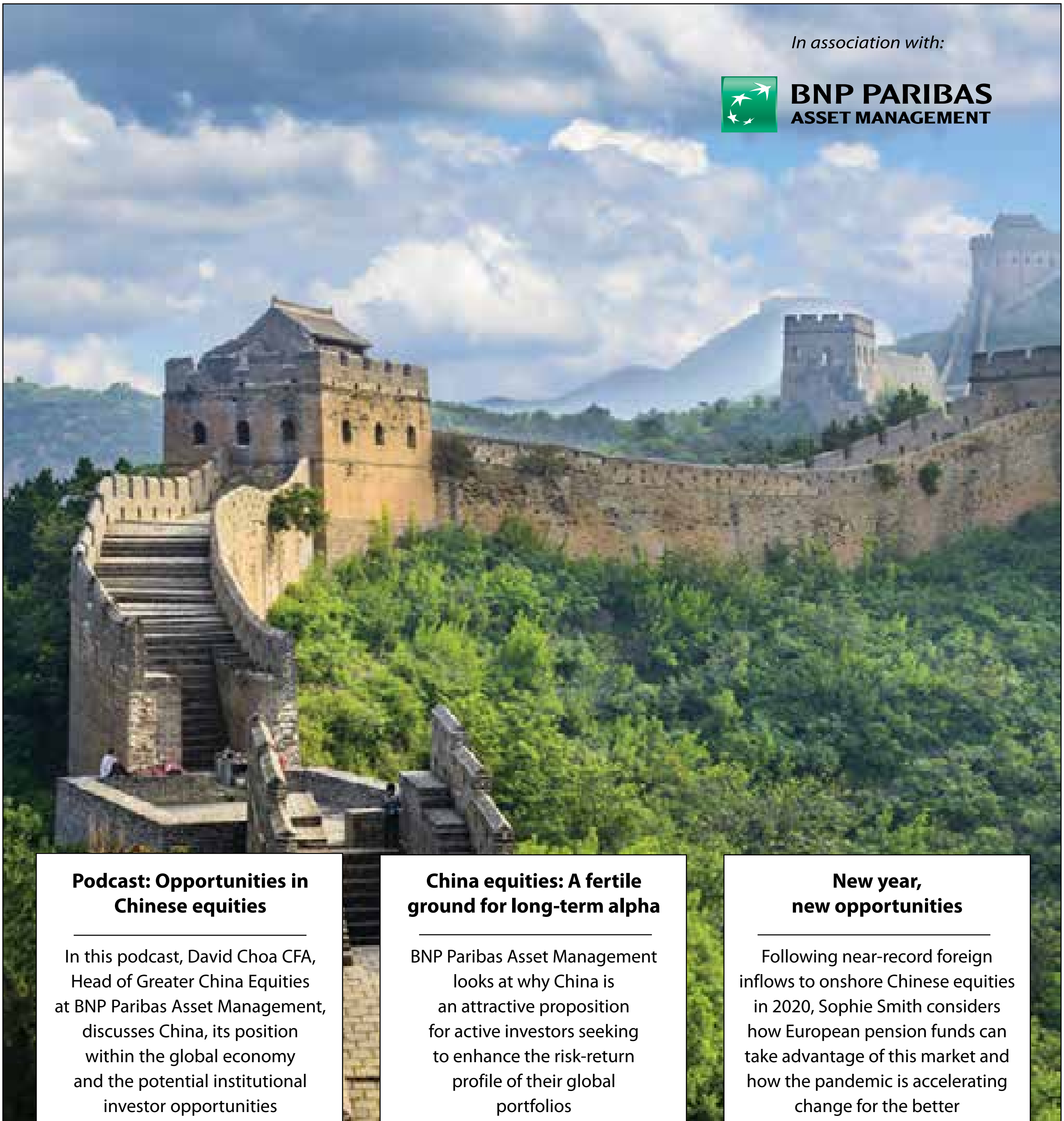
Chinese equities focus:
THE LAND OF OPPORTUNITIES



Podcast: Opportunities in Chinese equities

In this podcast, David Choa CFA, Head of Greater China Equities at BNP Paribas Asset Management, discusses China, its position within the global economy and the potential institutional investor opportunities

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BNP Paribas Asset Management looks at why China is an attractive proposition for active investors seeking to enhance the risk-return profile of their global portfolios

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New year, new opportunities

Following near-record foreign inflows to onshore Chinese equities in 2020, Sophie Smith considers how European pension funds can take advantage of this market and how the pandemic is accelerating change for the better

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PODCAST

Opportunities in Chinese equities

China was the first country to be impacted by the coronavirus outbreak, which led to its economy plummeting. Since then, however, the country has managed to keep outbreaks of the virus under control and is experiencing a V-shaped recovery, with many areas returning to normal.

In this podcast, David Choa *CFA*, Head of Greater China Equities at BNP Paribas Asset Management **talks to** *European Pensions* Editor, Natalie Tuck**, about China, its position within the global economy and the potential institutional investor opportunities within Chinese equities**

Starting off with the macro view, taking the pandemic into account, but given the progress with the vaccines, do you feel investors are now more open to moving out of a 'safe haven' mode and are willing to look at more alpha-generating investments such as China for opportunities?

I think investors have already looked past Covid-19, since the development of the vaccine last November and we can all see the light at the end of the tunnel now. International investors, in particular, are becoming more interested in the Chinese story, not only because of the speed of the recovery but also because the regulator has actively relaxed the rules to attract more foreign capital.

On the domestic front, domestic investors are becoming more interested because of the positive stock performance last year and because China has allocated a relatively low weight of the wealth into the stock market relative to the property market. That's the upside and the sentiment is definitely turning.

China is also very dynamic because the market has a lot of new entrepreneurs and new business models and products are emerging. In addition, external pressures from the USA and from the Covid-19 pandemic have also contributed to this dynamism. The gap between the very good companies and average companies is widening and divergences are accelerating.

What this means is there is very good hunting ground for active managers that have a good track record, such as BNP Paribas Asset Management (BNPPAM). Having said that I think there are multiple variations in the Chinese market, especially in those industry leaders, the companies in the informatics scene are getting quite pricy. A lot of the multiple re-rating has already happened in the last year, so going into this year we will see a wider divergence of the stock performance but it hugely depends on the quality of the earnings delivery. And the recent resurgence of Covid-19 in China will be something to watch as it could definitely pose some risks on the moderating of the recovery that we have seen over the last 12 months or so.

As Biden's administration takes over, what are your first thoughts on Sino-US relations and what impact do you see this having on the Chinese equity market?

I think in general the sceptical view of the US on China is here to stay. We are entering a new era where the US is going to see China as a strategic competitor with a very different system.

I think it is unlikely that Biden will show any weakness in the beginning of the administration, nor do I believe that he wants to achieve a compromise on China by taking back tariffs, because it will only show that his predecessor's tactics on tariffs is the current one to take and I don't think that's the road he wants to go down.

Having said that I believe there will be some normalisation, because for the past four years, things were getting progressively worse. From this point onwards, I think relations are more likely to go up than down. There will be some room for cooperation between the two nations such as on climate change.

In addition, Biden also has a lot of opportunity because he has control of both the senate and congress. We must also not forget that Biden is not going to take a deal approach, it's not his way of doing things. His way of doing things is also about building alliances with China, which actually is good for China.

Do you feel Chinese equities are isolated from any global/macro risks? What do you see as potential barriers for investors currently? And, what should entice them to diversify into Chinese stocks?

I would say, no, as a short answer

because China is still part of the global financial system. Many local businesses are closely linked to the global business momentum. For example, China is a supplier of many international products but compared to others China is definitely in a better position to tempt investors to look more at this part of the world.

Fundamentally, China has a better grip of Covid-19, the country also has a more balanced economy these days with very robust consumption as well as a fast growing innovation sector in the technology and lifestyle sectors. It also has more firepower to spend on relief on the fiscal and monetary side. In addition, when it comes to financial market risks, China now has a better control of these systematic risks, than in the past.

In addition, China has been underweight by many international investors for a long time and the tide has just started to turn. As mentioned earlier, there have been many market reforms that make it easier for foreign capital to invest in the market and these days the Renminbi is on a much better footing; a stronger local currency will give international investors more confidence to invest in the market, and we have also seen a lot of liquidity over the past year.

Integrating ESG into any portfolio has become a key requirement for investors these days. How do you approach this as BNP Paribas Asset Management and what do you focus on when selecting Chinese stocks?

This is a very important topic. I would say that ESG in China is in its infancy but it is definitely becoming more important compared to the past. At the last government meeting in October 2020, they made it a central goal to put climate change at the centre of their agenda.

Realising how urgent it is for countries like China to achieve aggressive carbon neutrality targets, BNPPAM has devoted essential resources to identify opportunities in the new energy transition stakes like the electric vehicle supply chain. We believe that such new opportunities will be big and we have been allocating resources to studying this because we want to capture this market trend.

I also think BNPPAM have the edge with the support from our sustainability centre. As China is increasing its fight against climate change we are increasingly seeing more and more Chinese companies appreciating our expertise on the topic. For us, ESG is not a separate track, but actually something already integrated into our daily investment process.

Finally, can you summarise the opportunities for investing in Chinese equities?

Our team focuses on three key areas in China; firstly innovation. China is putting a lot of focus on promoting technology development. Not only because it can diversify the country away from US dependency but China has a large industrial sector that urgently needs to upgrade productivity. That means that the beneficiaries will go beyond the traditional technology enablers, for example, other players like lifestyle or traditional companies that have stopped digital transformation will benefit from this innovation trend.

Second, is consumption; we are already of the view that China wants better physical products, actually what Chinese people want is a better lifestyle. That means the beneficiaries will go beyond the traditional retail sectors, for example, to other players in education, health, wellness, entertainment and food consumption.

The final thing we are focusing on is consolidation. There is no doubt that China is slowing down in terms of growth after a decade of fast growth. These days they need to think about, for example, research and development, productivity and cost. Those companies that adopt this mind-set, we believe, will pull away from the competition and consolidate the market. This will happen not only in the old industries but also in the new sectors. Basically these big themes are the ones that we are focusing on and we believe they will stand the test of time regardless of external factors like Covid-19. We also believe that the behaviour and the market characteristics both on-shore and off-shore will gradually converge and each of those markets will have their unique selling opportunities and we believe all China is the best of both going forward. ■

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INVESTMENT

China Equities: A Fertile Ground for Long-Term Alpha

WRITTEN BY DAVID CHOA CFA, HEAD OF GREATER CHINA EQUITIES FOR BNP PARIBAS ASSET MANAGEMENT

In these extraordinary times the investment potential in Chinese equities remains extraordinary.

This might sound debatable given current global uncertainties, but at BNP Paribas Asset Management, we believe the long-term growth prospects of China's vast, diverse equity markets and a steady move towards sustainable, quality growth, make a very attractive proposition for active investors seeking to enhance the risk-return profile of their global portfolios.

Reasons to invest:

1. Untapped opportunity in China's long-term (quality) growth path

Once the pandemic has passed, powerful domestic tailwinds such as urbanisation and a growing middle class will continue to drive China's GDP growth and productivity. Underpinning this, the government has firmly refocused its economic growth strategy away from sheer volume and speed and towards stable, high quality, higher value development.

2. Chinese equities: a vast, accessible market

The total market capitalisation of Greater China onshore (Shanghai and Shenzhen stock exchanges) and offshore equity markets (Hong Kong stock exchange) is over USD 14 trillion. China onshore account for about USD 10.5 trillion of listed market capitalisation, across some 3,800 stocks[1], making the onshore market one of the world's largest after the New York Stock Exchange and Nasdaq.

Unlike China offshore equity market, China A-share market still presents a relatively high number of momentum-driven retail investors. Yet in recent years, the retail/institutional balance is changing. The increasing participation of foreign capital will create a more balanced investor structure in the market. A higher institutional presence will help to improve corporate governance at China A-shares companies, which should benefit shareholders over the long term.

3. A-shares and H-shares: complementary markets bringing diverse opportunities

China's onshore and offshore equity markets are complementary, with China A-shares providing more diversified access to structural growth opportunities. There is a significant difference in sector weights between the different types of shares.

While Hong Kong-listed companies have tended to be dominated by large, state-owned financial and energy firms, China A-shares provide more exposure to privately-owned companies in consumption-driven industries. Unlike H-shares, A-shares offer unique access to growth opportunities such as Chinese pharmaceutical companies providing diabetes treatments for the ageing population.

By investing in both China's A and H-shares, investors can benefit from sector diversification and a broader opportunity set for alpha generation.

Forecast 2021: post-pandemic growth
15 economies expect to account for 74% of global growth in 2021

Source: Bloomberg analysis taking data from the international monetary fund. Notes: Growth forecast for each individual economy as a % of world GDP growth between 2020-2021. Based on purchasing power parity.

[1] Source: Wind, FactSet, Goldman Sachs, as of 23 October 2020.

4. Under-explored market offers mispricing opportunities
Importantly, there is a lack of coverage of Chinese stocks by sell-side analysts. The quality of domestic broker coverage in A-shares also tends to be weak.

A focus on ESG is critical when investing. This is especially true for A-shares, where ESG analyses are still complicated by low levels of data availability. Despite some risk factors related to investing in Chinese companies (e.g. corporate governance and stock suspensions), China policymakers are now making efforts to address these concerns, as they seek to attract more foreign investment.

5. A-shares: different can mean good
China A-shares have some features that set them apart from typical China exposure in a global portfolio. Typically, the bulk of their revenue is domestically driven, and thus less sensitive to global macroeconomic trends and shocks. A-shares also have a low correlation to global equities, and this, plus ample liquidity, means they can provide an effective means for diversification.

While exposure to Chinese equities can appear challenging from a risk-return perspective, the diversification in the portfolio mitigates this to some extent, such that risk-adjusted returns may actually improve. As a result, adding China A-shares can potentially enhance the risk-return profile for an emerging market (EM) portfolio as well as a China offshore equity portfolio.

6. Further inclusion in indices
The decision of the key global index providers (MSCI, FTSE, S&P) to include more China onshore companies in their indices was a significant milestone in the mainstream acceptance of Chinese equities in international portfolios.

7. Attractively valued
China A and H-shares markets are reasonably priced relative both to those of developed equity markets and to their historical average. The MSCI China (offshore) and CSI 300 (onshore) indices are attractively valued at around 15.1x P/E and 14.8x for the 12-month forward P/E, respectively (as of 3 December 2021) which represents a discount compared with MSCI US, MSCI Europe and MSCI World indices.

Three structural trends for long-term sustainable opportunities

Technology innovation: China has shifted from cheap labour-based manufacturing towards medium to high-end manufacturing. This is further supported by the size of the domestic market, higher R&D spending and a vast talent pool. Examples include not only information technology, but also sectors related to capital goods, industrial automation, new industrials.

Consumption upgrading: We see significant long-term growth opportunities for leading companies, in goods, as well as services. A number of these domestic winners are already emerging as multinational corporates, supported by rising household incomes, low household debt and more diversified consumer profiles. The current COVID-19 crisis notwithstanding, we believe this will accelerate in the next five to 10 years.

Globally-backed local expertise

We believe there is a significant investment opportunity in Chinese markets, driven by the growing acceptance of Chinese equities in institutional portfolios, and the changing nature of China's economy, prompting the emergence of globally recognised Chinese companies. Local expertise is needed to navigate the Chinese markets successfully and our Greater China Equities team, based in Shanghai and Hong Kong, manages or advises assets totalling more than USD 2.5 billion (as of 31 December 2020). ■

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INVESTMENT

New year, new opportunities

Following near-record foreign inflows to onshore Chinese equities in 2020, Sophie Smith **considers how European pension funds can take advantage of this market, and how the pandemic is accelerating change for the better**

WRITTEN BY SOPHIE SMITH

Investing in China is not a new concept. For European pension funds there are several strategic reasons to invest in Chinese equities, as well as ongoing trends in the market that back-up the prospect of long-term investment opportunities [*as outlined on page 20*].

Indeed, AXA Investment Managers senior economist, Aidan Yao, argues that an investor will not be able to replicate a well-diversified global equity portfolio by ignoring China, particularly as the latter is now part of many global equity indices. "For long-term investors like pension funds," he says, "China offers size, liquidity, diversity, strong growth fundamentals and very competitive valuations."

This is echoed by Willis Towers Watson director and China specialist, Liang Yin, who highlights Chinese onshore equities in particular as holding significant diversification benefits to global investors. Furthermore, he stresses that whilst the Covid-19 pandemic has created short-term challenges for the Chinese economy, it has also highlighted its resilience.

"Having strongly bounced back from the first quarter decline, China is expected by the International Monetary Fund (IMF) to be the only major world economy to post positive 2020 growth," he states, noting that, over the course of 2020, the MSCI China A index has also outperformed the world index by 27 per cent.

Agreeing, Yao argues that despite the unfortunate politicisation of this crisis, investors seem to have a clear focus on the economics. "China's achievement in combating the virus and restarting the economy has been well recognised by investors, domestic and foreign alike," he explains, highlighting the near record foreign inflows to A-shares seen in 2020, which made it the best performing market in the world, as testament to rising investor confidence in China and its equities.

Accelerating the pace

Covid-19 has also sped up China's transformation by reinforcing the forces of de-globalisation and economic decoupling from the US, highlights BNP Paribas Asset Management (BNPPAM) Greater China senior economist, Chi Lo, in a recent paper, *China's opportunties and challenges in 2021 and beyond,* predicting long-term investment opportunities in the tech-based domestic-driven growth areas.

"China has so far achieved better control of Covid-19 than many other major economies," adds BNPPAM head of Greater China equities, David Choa, in the article, *Why this time may be different for Chinese equities,* arguing that equity markets are now on much better footing.

Covid-19 is not the only potential obstacle though, as Redington head of manager research, Nick Samuels, acknowledges that there are often concerns around politics and environmental, social and governance (ESG) issues.

In his report, however, Choa argues that the country would have "considerable fiscal and monetary power" to maintain stability if needed, such as in the case of a resurgence of Covid-19 or greater geopolitcal tension.

Furthermore, Yin says that whilst these tensions and negative rhetoric are overshadowing the fundamentals of the business environment, this is not an obstacle for all investors.

"For global investors who have a long time horizon, rather than weaken the case, these factors actually reinforce the need to own more Chinese assets to make their portfolios more resilient in a changing and uncertain world," he explains.

In addition to this, Yao highlights "significant improvements" that have been made in market accessibility through the creation of Qualified Foreign Institutional Investor (QFII), Renminbi Qualified Foreign Institutionl Investor (RQFII) and equity connect mechanisms, stressing that the near-record foreign inflows to onshore equity last year would not have been possible without easy access to the market.

More broadly, he emphasises that whilst China could present unwanted risks e.g. different regulations and opaque policy making, these have declined as China reforms and liberalises its markets.

"China's economy is now better balanced than in the past," agrees Choa in his report, highlighting constant structural economic reforms, which have helped to shift consumption and investment to meet domestic demand.

"At the same time," Yao clarifies, "one has to recognise that these risks are fairly common in emerging markets as macro infrastructure is still under rapid development. The fact that emerging markets offer a risk premium over developed markets is precisely for these reasons. We see this as offering exciting opportunities for active investment over passive index tracking when it comes to investing in China."

It is perhaps unsurprising then that Yao predicts significant potential for European pension funds to embrace the Chinese markets in future. "In particular, as China makes further inroads in global indices – A-share's current weight is less than 1 per cent in MSCI ACWI, which is clearly incompatible with China's economic and market sizes – global investors, including Europe's pension funds, will be compelled to invest to avoid tracking error," he says.

"In addition, China's long-term development plans – including carbon neutrality, financial market liberalisation, raising the middle-class and moving up the tech/innovation ladder – could also present secular opportunities that match pension funds' long investment horizon."

A sustainable change

In fact, these trends seem to have already fed through to issues around sustainability, as Samuels says that whilst there are valid concerns around ESG issues, this is why selecting a fund manager with strong ESG integration is very important.

"The level of disclosure in China listed companies is actually very high, and many Western companies are not immune to questioning of the labour issues in their Chinese supply chains, so as always the devil is in the detail," he says.

Yao backs this up, pointing out that ESG is "very trendy" in China, particularly after Beijing's pledge to be carbon neutral by 2060 and foreign investor participation increased. He adds: "It's hard to find any major investment forums in the last 12 months that did not feature discussions on ESG. Industry bodies, such as the Asset Management Association, have issued guidelines on ESG practices, while more and more listed companies have started to highlight their ESG consideration and try to operate businesses in socially-responsible and environmentally-friendly ways."

Yin agrees that ESG challenges are not insurmountable, stating that investors should focus on identifying highly skilled active managers given the varied practices in China.

Staying active

BNPPAM also highlights a focus on ESG as particularly critical for A-shares, where analyses are still complicated by low levels of data availability, emphasising that active managers are well placed to take advantage of both offshore and onshore opportunties, thanks to their ability to undertake on-the-ground research, as well as having long-term investment horizons allowing them to benefit from the low market efficiency.

Alongside active management, Yin recommends specialist China-focused mandates, citing research which found that the median active China A share manager has outperformed the benchmark by between 4 per cent and 7 per cent over most time horizons.

"A key reason behind this is that the Chinese market is dominated by retail investors who tend to be short term, are momentum driven and pay less attention to corporate fundamentals," he explains, stating that their presence exacerbates market volatility and creates opportunities for managers with pension fund clients who can take a longer-term view.

Samuels agrees, describing the market as very inefficient and a great place for active managers, with some outperforming by as much as 40 per cent in 2020.

In his report, Lo also says that given its long-term policy and growth aspirations to be a global economic power, Chinese assets should become an asset class in their own right, rather than being part of a broader emerging market allocation. "International benchmark providers have already been increasing the share of Chinese assets in their stock and bond indices," he concludes.

Yin recommends moving towards an allocation of as much as 20 per cent to China in investors' growth portfolios over the next 10 years, up from the current average of 4-5 per cent. "Building exposure to China should be a journey that balances the pace of market improvements with the imperative to achieve diversity in a global portfolio," he emphasises, "and the time to start building that knowledge and exposure is now." ■

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