INVESTMENT

# China – a break in the clouds

**Francesca Fabrizi looks at why China could offer some promising investment opportunities for European pension funds in the long term, despite all the current doom and gloom**

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It's hard to find ways to describe what's been happening in the global economy in recent months without focusing too much on the negative; and anyone managing a pension fund portfolio may be tempted to believe that it's all bad news.

However, despite the unsteady markets, there are still opportunities to be had across the globe for pension funds looking to enhance the risk-adjusted returns of their global portfolios, particularly in the long term – China being a prime example.

As outlined on page 20, there are several strong strategic reasons to invest in Chinese equities, as well as structural trends which back-up the long-term sustainable opportunities offered by this vast, dynamic and diverse country. For pension funds and other institutional investors, one of the key features of this market is that onshore equities (which include stocks that are traded on the mainland Shanghai or Shenzhen stock exchanges, as opposed to offshore, which are listed on the Hong Kong stock exchange) are so much more accessible to global investors than ever before.

But while that may be the case, it is, for many European pension fund investors at least, still early days for them to take advantage of these opportunities, according to Willis Towers Watson senior director of investments, Tom Brooke-Smith.

"It's important to note that we remain in the early stages of Chinese onshore asset integration within a global investor's opportunity set. Chinese onshore markets are large, either the second or third largest in the world, and so naturally offer a number of interesting opportunities.

"However, they also remain immature from a number of perspectives, such as the development of a consistent bankruptcy code. Therefore, whilst we have made steps towards integrating Chinese assets within our client portfolios, we have remained relatively cautious to date. We have participated in government/policy bank bonds and selectively within equity markets," says Brooke-Smith. Both allocations, he adds, have been made on an active basis as the firm sees value in skilled active management, given the idiosyncrasies of the markets in question.

Looking ahead, however, interest from Europe's pension funds is likely to increase significantly from hereon in. Redington senior vice president, manager research, Oliver Wayne – who has worked with several European pension funds, helping advise them on standalone allocations to Chinese equities as well as via emerging markets allocations – agrees that, while up until recently it was difficult for European and other foreign investors to access the onshore market, this has now changed dramatically, meaning more clients are likely to want to take advantage.

"With increased financial liberalisation, the majority of the onshore market capitalisation is now easily accessible to outside investors. As a result, we expect to see further traction with clients on a forward-looking basis," he predicts.

So, with the onshore market having opened-up, what can these new opportunities potentially bring to European pension fund portfolios?

Historically, Chinese onshore equities provided investors with a diversification benefit relative to their other asset holdings, Brooke-Smith explains: "We see benefits to holding an allocation to this market from a structural perspective, assuming returns are attractive enough. We think there is a strong economic underpinning for this diversification, and so believe equities are an attractive portfolio holding if purchased at the right price."

The Chinese market, he qualifies, has been through several valuation swings over the course of the last decade and so market timing is essential to success. "As importantly," he adds, "active stock selection is also key. This is true from both a risk management perspective, where we place significant weight on a strong environmental, social and governance (ESG) process, and also on return generation by finding companies that are focused on generating shareholder value."

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This argument for active management is backed-up by Wayne, who believes there to be a strong case for an active approach in China. He argues: "The market is far more inefficient and under-researched than developed counterparts and, as such, we believe this creates a fertile hunting ground for stock pickers with a long-term view."

Redington has completed extensive on-the-ground research in China and the potential for scalable alpha is, in his view, unparalleled. "This view is predicated on the high dispersion of returns created by the deep retail investor base and the low experience levels of the domestic mutual fund managers," he adds.

## An all-encompassing solution

The arguments for European pension funds to invest in Chinese equities are, therefore, plentiful; what is less clear is what approach they should take to get the most out of China's prospects. BNPP AM head of greater China equities, Caroline Yu Maurer, argues that pension funds should opt for an all-China equity solution in order to get access to the full opportunity set in Chinese equities, thereby maximizing returns potential.

Maurer explains: "Access to A-shares has never been easier for global investors. Historically, access was limited to large Chinese companies listed on global equity markets (e.g. Hong Kong), or cumbersome through capital-controlled investment programmes (e.g. QFII/RQFI)."

However, with the Stock Connect programme launched in 2014 linking the Shanghai/Shenzhen to Hong Kong markets, there is no restriction on repatriation, capital can be deployed quickly, and the eligible investment universe gathers over 1,500 stocks listed in Shanghai and Shenzhen, "offering abundant alpha opportunities," she says.

Alongside this, H-shares and American Depositary Receipts (ADRs) also provide appealing features. "H-shares invariably trade at lower prices than their equivalent listings on mainland exchanges, while ADRs also present opportunities particularly for large-cap technology-related names," she continues.

Therefore, by opting for an All-China equity solution, pension funds can benefit from relatively stable returns from China offshore equities, coupled with diversified opportunities and higher dispersion of returns from China A-shares.

In addition to the large opportunity set, A-shares provide more diversified access to structural growth opportunities, a complement to the China offshore exposure.

Yet, A- and H-shares have shown performance divergence, warns Maurer. Between 2003 and 2019, the CSI 300 index (China onshore) outperformed the MSCI China index (offshore) only six years out of 17 years. "As A-shares tend to be less sensitive to global sentiment, its correlation with the rest of the world remains low. Therefore, adding China A-Shares can potentially enhance the risk/return profile for an emerging market equity portfolio and even for a China offshore equity portfolio," she confirms.

## ESG gaining ground

A further positive for China as an investment opportunity is its growing recognition of the importance of strong ESG practices, something that all European pension funds were increasingly focusing on before the crisis and will likely continue to do so going forward.

Maurer explains: "China is serious on ESG reporting, with regulators requiring companies to improve communication and transparency on their ESG risks."

There is, however, some way to go and, for a number of Chinese firms, ESG reporting still remains a box-ticking, compliance-driven exercise – all the more reason why the right expertise is essential. Maurer continues: "ESG analysis in China is complicated given the low levels of data availability and data quality. As China A-shares have been partially included in mainstream international indices, it is becoming particularly critical for global investors to know how to quantify and measure ESG analysis in China."

Maurer believes, as do many investors today, that companies with sound or improving ESG practices are typically of a higher quality and more likely to generate sustainable earnings over the long term. "Integrating an analysis of relevant and material ESG issues alongside financial analysis of companies should help investors achieve long-term investment objectives.

"Meanwhile, company engagement can help bridge data gaps, with a focus on material issues. Therefore, this stresses the importance of having the right resources to support the investment decisions," she concludes.

All in all, while in the short term the challenges are abundant for institutional investors today, a look into the longer term does offer some hope. As Brooke-Smith concludes: "We remain in the opening plays of Chinese capital market integration, but we believe this trend will continue over the coming years. China may not be linear in its opening up process, but the long-term direction is clear. As market access expands, new opportunities will arise for global investors." ■

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