China Insights: an active approach to uncovering opportunities

Too big to ignore

Going beyond home bias is a perennial challenge to investors in any asset class.

For many based in developed markets, this manifests itself as a relative aversion to global emerging markets equities generally, and furthermore towards specific regions and individual countries.

Yet from a top-down perspective, this is an increasingly difficult argument to hold. Almost 60% of the world's population lives in Asia, with some 18% in China alone[1].

The World Bank notes that "since China began to open up and reform its economy in 1978, GDP growth has averaged almost 10% a year, and more than 800 million people have been lifted out of poverty. There have also been significant improvements in access to health, education, and other services over the same period."

The advances have manifested themselves in its macroeconomic standing. China is now the world's second biggest economy[2].

For investors, the challenge has therefore shifted. There is no dearth of economic opportunities in China. Instead, they now need to ensure that they maximise opportunities that are securitised.

That point is illustrated by the MSCI All Country World Index, which as of April 2021 had a weighting of just 4.8% to China, versus 58.4% for the US.

But, in the same way that an investor in, say, the eurozone is unlikely to have more than half their equity risk asset exposure in US securities, equally it would seem imprudent to have such a small exposure to the opportunities present in China. This, incidentally, is also a reason why the country ought to be split out from a generic global emerging market allocation, which risks not only maintaining an underweight relative to the importance China now constitutes in all economic activity, but also potentially short-changes investors who really need to access improved alpha generating opportunities in public markets.

Rising disposable income there is driving services businesses in areas such as education, tourism, entertainment, healthcare and financial services. The government has signalled strong support for environmental protection. China has competitive advantages in sectors such as electronics, textiles and automotive. And there are ongoing supply side and ownership reforms.

Sources
1. Statista, Worldometer, United Nations Department of Economic and Social Affairs
2. International Monetary Fund World Economic Outlook Database April 2021

Additionally, from a technical point of view, the Mainland China equity markets remain relatively inefficient. This is down to factors such as short-term investment horizons driving high daily turnover, crowding in the market increasing volatility, and significant variation in the quality of stocks, which has led to wider dispersion in historical share price performances.

As Sumitomo Mitsui DS Asset Management analysts note: “We believe China will continue to outpace western nations and Japan in terms of both overall growth and per capita basis.”

Domestic consumption is a recognised growth factor at the macro level. However, arguably also important for investors is a commitment at the micro level to maintaining dividend growth, which is linked to balance sheet conservatism.

By focusing on China investors can benefit from the growth of China as a proportion of the world economy, can tap into breadth and diversity of companies in the country, and find low correlation to other markets.

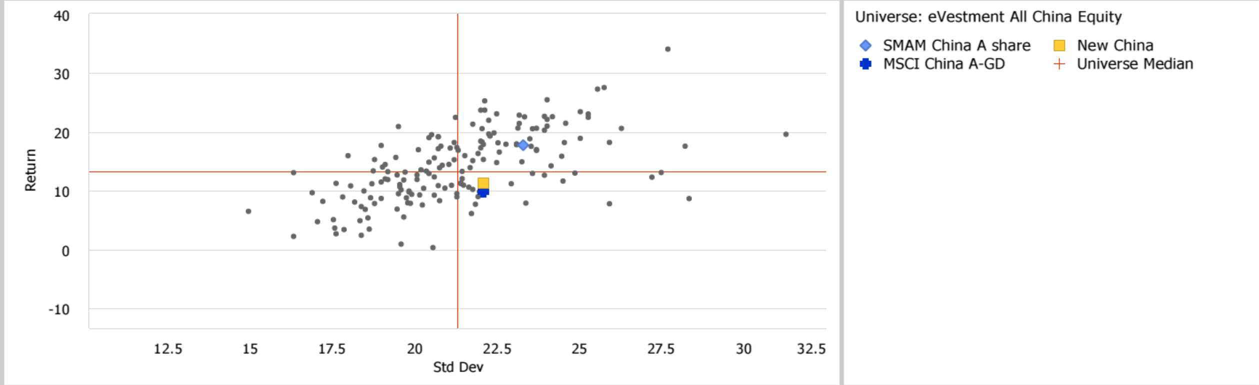
Why pursue an active China strategy?

Investors can approach Chinese equity markets through collective investments in two ways: active and passive.

The latter has proven popular in recent times, especially in the guise of exchange traded funds (ETFs). However, tracking inefficient markets through an ETF raises questions about the degree to which alpha can be generated. And when it comes to Chinese listed equities there are peculiarities that investors need to keep in mind.

One of the concerns expressed about the passive approach is that because MSCI has been progressively increasing China A Shares as a portion of its MSCI Emerging Markets Index, performance can vary depending on how much investors allocate to the asset class. SMDAM believes that allocation to China A Shares should be decided by allocators and investors rather than by MSCI.

Risk-Reward (3-Yr)

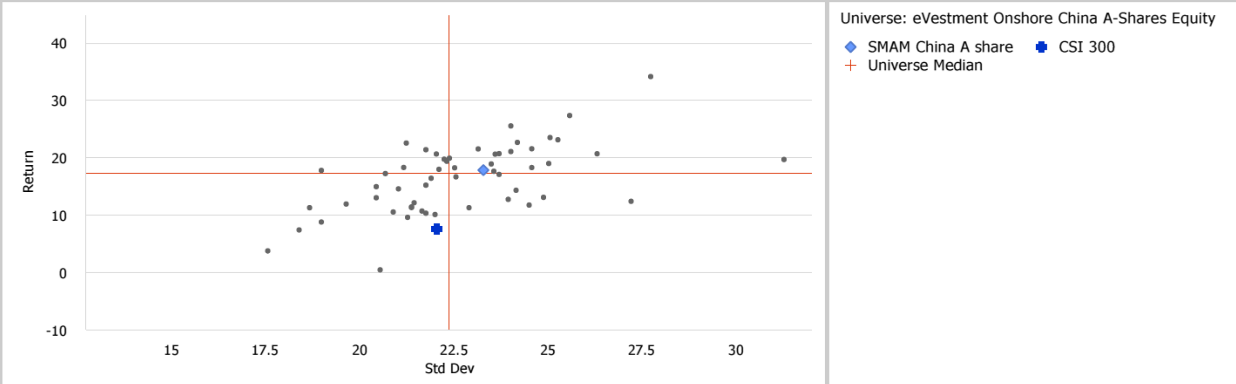


Risk-Reward (3-Yr)

Product Name	Returns	Std Dev	Alpha	Beta	Batting Average	Info Ratio	Up Mkt Capture	Down Mkt Capture	Tracking Error	Treynor
SMAM China A share	17.74	23.31	7.74	0.99	0.56	0.96	110.71	86.83	8.27	16.43
New China	11.30	22.12	3.28	0.84	0.53	0.12	92.09	89.65	12.39	11.57
MSCI China A-GD	9.82	22.11	0.00	1.00	0.00	---	100.00	100.00	0.00	8.28

Source: eVestment as at 31 March 2021

Risk-Reward (3-Yr)



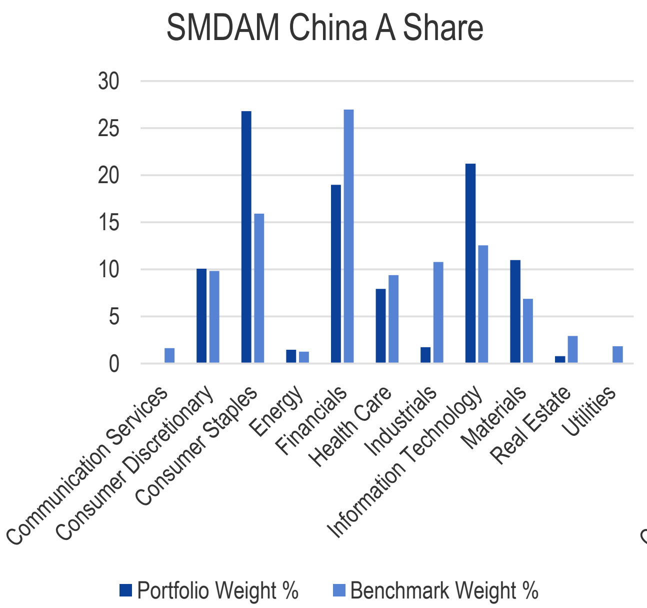
Risk-Reward (3-Yr)

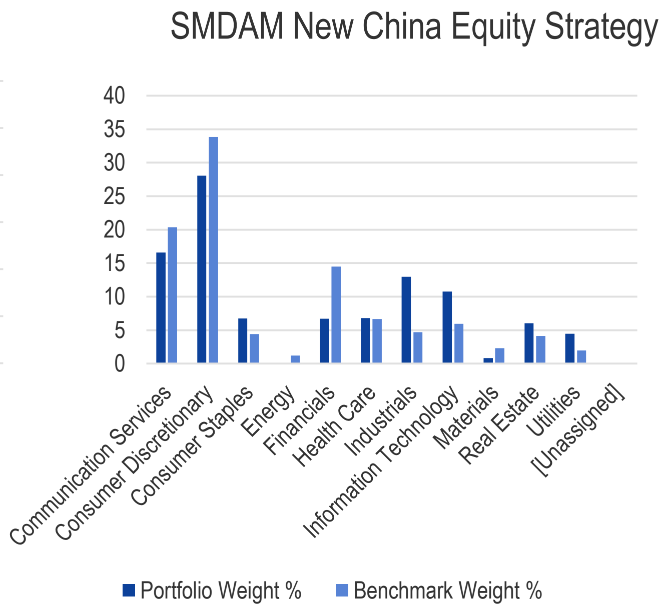
Product Name	Returns	Std Dev	Alpha	Beta	Batting Average	Info Ratio	Up Mkt Capture	Down Mkt Capture	Tracking Error	Treynor
SMAM China A share	17.74	23.31	10.20	0.97	0.64	1.09	117.99	86.65	9.38	16.73
CSI 300	7.52	22.05	0.00	1.00	0.00	---	100.00	100.00	0.00	5.98

Source: eVestment as at 31 March 2021

Another point is that the dynamics of the China A Shares onshore markets are different from those of other emerging markets. This means it can be more effective and efficient to assign management of China A Shares to a dedicated manager, separated from those managing the rest of the EM universe.

For the portfolio managers at SMDAM looking at China A Shares through its two relevant strategies - SMDAM New China Equity Strategy (inception 2001) and SMDAM China A Share Strategy (inception 2007) - this separation means they can focus their attention on quality companies that are positively impacted by China's changing demographic and economic environment. In turn, this offers investors in Europe better risk-adjusted return and exposure than possible through, for example, MSCI indices.





Source: SMDAM, data as at 31 March 2021

Sumitomo Mitsui DS Asset Management

Per the point on market inefficiencies noted earlier, SMDAM sees China A Shares being traded in an immature capital market. This is a factor giving rise to the ability to generate alpha through active stock selection.

There is also the matter of long-term investment horizons to consider and managing downside risk. Both are seen as critical to achieve improved risk-adjusted returns, given the high level of volatility seen in local markets amid the shorter investment horizon of many local market participants.

Remember, too, that investing into China A Shares requires special arrangements and licenses such as QFII and Stock Connect (which requires RMB cash as it is T+0). Moreover, most corporate and market information is available only in Chinese currently.

ESG & China

SMDAM's portfolio managers see China as a heterogeneous investment market undergoing rapid growth and change. In this it is also important to have an active approach that can incorporate ESG, to take best advantage of the opportunities present.

It is no secret that the spectrum is broad when it comes to company specific ESG policies and accessibility to ESG data in China. That said, there are an increasing number of local agencies participating in setting up ESG standards in Mainland China.

For its part SMDAM is focused on the impact of ESG factors on financial performance – so called materiality. Again, this is seen as a source of alpha, precisely because of the large divergence of ESG adoption by companies amid ongoing regulatory initiatives. It also presents an opportunity to execute against a proprietary ESG rating approach.

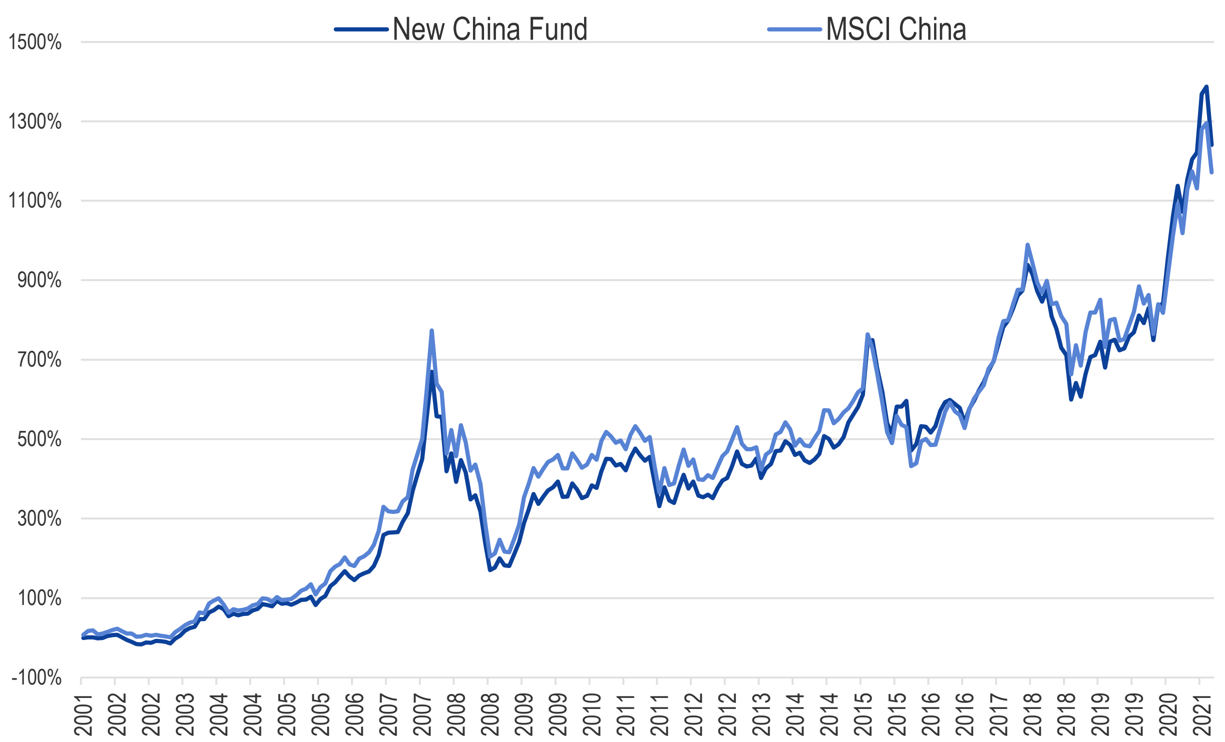
The practical application of this involves negative screening applied in the top-down analysis, with in-house ESG evaluation applied to the bottom-up analysis. ESG is evaluated in terms of the weighted average cost of capital calculations applied to individual companies, and a further ESG risk control applied during portfolio construction.

Collectively, this covers the stages of investment ideas generation, stock selection as a source of alpha, and portfolio risk monitoring.

Attractive holdings from an ESG perspective are those that pass the negative screening for factors such as severe ESG risk/controversy, which are deemed by the proprietary ESG rating as best-in-class and carrying momentum and opportunity in terms of ESG, and where the fundamental research identifies a benign industry outlook from an ESG perspective, with company specific catalysts and positive earnings forecasts. Once invested, the ESG risk monitoring looks to lower the portfolio ESG risk, ensure lower carbon intensity, and ensure favourable comparison to the benchmark index.

Performance since inception

Source: SMDAM as at 31 March 2021



Source: SMDAM as at 31 March 2021

Why consider SMDAM?

Investing in China broadly means considering opportunities in Mainland China, Hong Kong, Macao and Taiwan.

SMDAM approaches these opportunities via two equity strategies.

The SMDAM China A Share Strategy references the universe of the CSI 300 benchmark, a composition of large stocks listed in Shanghai or Shenzhen:
- It is focused on China A Shares.
- It seeks out quality growth companies.
- The inception date is 10 April 2007, and it currently has AUM of some USD15 million.

The SMDAM New China Equity Strategy references the universe of the MSCI China benchmark:
- It encompasses China H Shares, A Shares, B Shares, Red Chips and ADRs.
- It seeks out quality growth companies .
- The inception date is 22 October 2001, and it currently has AUM of some USD330 million.

SMDAM has been investing into Mainland China listed equities since 2003, and before that via Hong Kong listed Mainland stocks. As a Japan based asset manager, there would have been some exposure before that via holdings in Japanese companies, which began investing in China in the 1980s, as part of their direct fixed investments.

A key advantage SMDAM brings is its own background. As a Japan based manager, it has not only had a long history considering the impact of China on its investments, initially indirectly via its holdings in Japanese companies, and latterly via its own investments in Chinese domestic securities, but it also benefits from geographical proximity to the Chinese markets.

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Risk warning: On 1 January 2021 the UK left the EU transitional arrangements and no longer benefits from passporting rights into EEA countries.

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