China A-Shares: Perspectives From the Inside Out

A large and liquid domestic equity market in China is shaping up to be one of the world’s biggest investable universes. To capture the generational opportunity of China A-shares, international investors need to navigate a unique environment that’s a source of both risk and alpha.
China’s onshore equity market — the world’s second-largest in terms of market capitalization — has never been more accessible to international investors. However, finding a strategy suitable for a market whose dynamics and characteristics are decidedly different from those of most other markets in the world can be a challenge.

Here, we provide international investors with insights into navigating China’s market anomalies from an onshore perspective and present the case for a systematic approach to alpha generation.

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Capturing China’s growth opportunities

In the 40 years since Chinese leader Deng Xiaoping launched unprecedented market-oriented reforms, China has metamorphosed into a global economic power faster than any other country in history. China has eclipsed several developed economies in many respects, from the symbolic (e.g., half of the world’s top 10 tallest buildings are in China) to the significant (e.g., it is the largest contributor to global GDP in purchasing power parity terms). And it is not about to stop here — we expect real GDP in China to grow at more than twice the pace of that in the US and run ahead of most economies in the world.

Over the years, China’s domestic equity market has grown to become the world’s biggest and most diverse universe for long-term growth opportunities in China.

- The domestic A-share market offers the biggest and most diverse universe for long-term growth opportunities in China.

- Despite its size and liquidity, the A-share market remains highly inefficient and idiosyncratic – providing plenty of opportunities for active investing.

- Local knowledge and a systematic approach attuned to the distinct factors driving the A-share market provide opportunity for consistent alpha generation.

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Over the years, China’s domestic equity market has grown to become the world’s second-largest in terms of market capitalization at US$6.8 trillion, with an average turnover of US$56 billion.2 Previously closed to foreign participation, the onshore market has opened to global investors in recent years, with many international portfolios today holding increasing, albeit still small, exposures to the local currency-denominated, domestically listed A-share companies through MSCI and other benchmarks.3

1Bloomberg, as of 31 December 2018.
2Bloomberg, as of 31 December 2018. Average turnover is calculated based on 2018 yearly average value per trading day.
3After the landmark partial inclusion of A-shares into the MSCI Emerging Market Index in 2018, the weight of China A-shares in the index is less than 1% as of 31 March 2019, but is estimated to increase to 3.3% by late 2019, according to MSCI.
China's long-term prospects rest on its critical pivot from the industrial-led growth formula that steered the country to its current economic status in favor of “new economy” growth drivers like consumption and information technology. Policymakers view this generational shift as essential in sustaining Chinese growth and prosperity well into the future.

On the ground, we see technological innovation, evolving consumer trends, financial reforms, and trade reshaping Chinese business models.
The “factory of the world” image of China is gradually giving way to a high-tech China, aided by increased spending in research and development that is expected to outstrip the US and eurozone economies in a few years. Although China is still behind in many areas, significant amounts of state and venture capital investments are pouring into key technological areas, such as virtual reality, autonomous vehicles, 3-D printing, robotics, drones, and artificial intelligence (AI). With China already regarded as the second-largest AI ecosystem in the world, the government aims to make it a global leader by 2030.

The rise of China’s middle class and millennial generation also portends a disruptive force that is likely to yield new investment opportunities. Total retail e-commerce sales in...
China have eclipsed those of the US since 2013, accounting for 56% of the value of global retail e-commerce transactions by the end of 2019. At the same time, China is deepening its global economic influence with the ambitious “One Belt, One Road” infrastructure and trade initiative, connecting 65% of the planet’s population across Asia, Europe, the Middle East, and Africa.

This new era of transformation creates fertile ground for active investors who can identify companies that capitalize on these trends, evolve their businesses to be forward-looking, and have strong management and sustainable business models. With over 3,500 listed companies, the A-share market is the largest investible universe in which to capture these opportunities.

Why A-shares, and why now?

Before the opening up of the onshore market to foreign investors, direct investment into Chinese companies was done through overseas-listed share classes, such as H-shares, red chips, and P chips in Hong Kong and N-shares in the US. Among these share classes, H-shares had been the biggest in terms of market cap and offered the most diverse sector exposures. However, as China’s domestic economy flourished, the A-share market became more diverse and more liquid, and has surpassed H-shares in terms of market cap.

Net inflows into A-shares have grown significantly since China introduced direct access to the onshore market through the Qualified Foreign Institutional Investor (QFII) in 2002 and the Renminbi Qualified Foreign Institutional Investor (RQFII) in 2011. These initiatives were followed by the game-changing Stock Connect program linking the Hong Kong Exchange with the Shanghai Stock Exchange in 2014 and Shenzhen Stock Exchange in 2016, which allowed foreign retail and institutional investors the ability to trade A-shares via Hong Kong intermediaries.

Source: UBS, Wind, as of 31 July 2018.

More Channels Are Open for Foreign Direct Access to China’s Onshore Equity Market

<table>
<thead>
<tr>
<th>Eligibility</th>
<th>Coverage</th>
<th>Ownership Restriction</th>
<th>Other restrictions</th>
</tr>
</thead>
<tbody>
<tr>
<td>QFII</td>
<td>Approved institutional investors</td>
<td>Stocks listed on Shanghai and Shenzhen exchanges, bonds, ETFs, futures investment funds, warrants. Primary market participation permitted, including IPOs.</td>
<td>A single foreign investor’s shareholding in a listed company cannot exceed 10% of the company’s total issued shares. All foreign investors’ shareholding in A shares of a listed company cannot exceed 30% of its total issued shares.</td>
</tr>
<tr>
<td>RQFII</td>
<td>Approved institutional investors</td>
<td>Stocks listed on Shenzhen Exchange, Shenzhen ETFs, futures investment funds, warrants.</td>
<td>Daily trading quota on “net buy” basis; trading only when all three exchanges are open.</td>
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<tr>
<td>Stock Connect</td>
<td>No restrictions (open to local, foreign, retail and institutional investors)*</td>
<td>Authorized A-shares listed on the Hong Kong, Shanghai and Shenzhen exchanges; B-shares, rights issues, IPOs and ETFs are excluded.</td>
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</table>

Source: Hong Kong Exchange, PineBridge, as of January 2019. For illustrative purposes only. *Individual mainland investors must have an account balance of more than RMB500,000. +As of 1 April 2019, the Stock Connect had approximately 2,000 eligible stocks, including constituents of the SSE180, SSE380, SZSE Component index, SZSE Small/Midcap Innovation index with market cap of RMB6 billion or above, and any A-shares with dual-listed H shares.
Breadth and depth
The A-share market is the largest and most diverse Chinese equity opportunity set. While H-shares are dominated by financial stocks, A-shares better represent the evolving Chinese economy with more balanced weights across traditional sectors such as financials, industrials, consumer goods, and basic materials, as well as "new" sectors such as IT and health care. The A-share market enjoys vibrant trading by Chinese retail investors, which make up more than 80% of total trading volume.

A-Shares Better Represent China’s Evolving Economy

<table>
<thead>
<tr>
<th>Sector</th>
<th>A-Shares</th>
<th>B-Shares</th>
<th>H-Shares</th>
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<tbody>
<tr>
<td>Financials</td>
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<td>Real Estate</td>
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<td>Health Care</td>
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<td>Consumer Discretionary</td>
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<td>Industrials</td>
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<tr>
<td>Materials</td>
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<td></td>
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<tr>
<td>Consumer Staples</td>
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<tr>
<td>Information Technology</td>
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<td></td>
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<tr>
<td>Utilities</td>
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<tr>
<td>Energy</td>
<td></td>
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<td></td>
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<tr>
<td>Telecommunication Services</td>
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</tbody>
</table>

3,567 stocks
US$6.3tn market cap

99 stocks
US$19.9bn market cap

267 stocks
US$749.0bn market cap

163 stocks
US$675.6bn market cap

651 stocks
US$958.3bn market cap

198 stocks
US$656.6bn market cap

Source: Bloomberg, as of 31 December 2018. For illustrative purposes only. We are not soliciting or recommending any action based on this material. Diversification does not ensure against market loss.

Bloomberg, as of 31 December 2018.
CEIC, UBS-S as of 31 December 2018
Increasing relevance
The landmark partial inclusion of A-shares in the MSCI Emerging Markets Index in 2018 instantly increased the exposure of portfolios linked to the benchmark. A-share exposure will continue to expand to as much as 3.3% by late 2019 from less than 1% today as more companies are added into the index,\textsuperscript{10} which could drive an estimated US$60 billion to $89 billion in foreign fund flows into China’s onshore stock market.\textsuperscript{11}

While index inclusion by MSCI and others has significant flow implications, A-shares remain an underrepresented opportunity. Even at full inclusion, A-shares are estimated to account for only 16% of the MSCI Emerging Market Index.\textsuperscript{12}

Attractive valuations and returns
Aside from size and depth, the onshore market offers stronger and more persistent returns than major markets. Valuations remain attractive in terms of price to earnings growth – making Chinese equities a compelling addition to global portfolios.

Valuations Are Attractive

Source: Hong Kong Exchange, PineBridge, as of January 2019. In USD, countries and regions represented by MSCI indexes except Shanghai and Shenzhen composites, and CSI 300. An investor generally cannot invest in an index. For illustrative purposes only. We are not soliciting or recommending any action based on this material.

\textsuperscript{10}MSCI, as of 28 February 2019. The weight of China A-shares in other MSCI indexes are estimated to increase to: 10.4% in the MSCI China Index, 4% in the MSCI AC Asia ex Japan Index, and 0.4% in the MSCI ACWI Index.

\textsuperscript{11}UBS, as of 19 February 2019; Reuters 1 March 2019.

\textsuperscript{12}MSCI, as of 28 February 2019.
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Low correlations

A-shares also exhibit relatively lower correlations compared with other major equity markets, including EM, making them potentially effective diversifiers in a global portfolio.

A-Shares Have Relatively Low Correlation with Major Markets

<table>
<thead>
<tr>
<th></th>
<th>CSI 300</th>
<th>H-Shares</th>
<th>HK</th>
<th>Asia ex Japan</th>
<th>Japan</th>
<th>US</th>
<th>EU</th>
<th>EM</th>
<th>World</th>
<th>Avg.</th>
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<tr>
<td>CSI 300</td>
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<td>0.48</td>
<td>0.27</td>
<td>0.30</td>
<td>0.29</td>
<td>0.41</td>
<td>0.33</td>
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<tr>
<td>H-Shares</td>
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<tr>
<td>HK</td>
<td>0.45</td>
<td></td>
<td>0.78</td>
<td>0.87</td>
<td>0.54</td>
<td>0.50</td>
<td>0.55</td>
<td>0.82</td>
<td>0.61</td>
<td>0.67</td>
</tr>
<tr>
<td>Asia ex Japan</td>
<td>0.48</td>
<td>0.87</td>
<td>0.87</td>
<td>0.57</td>
<td>0.61</td>
<td>0.64</td>
<td>0.96</td>
<td>0.73</td>
<td>0.71</td>
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<tr>
<td>Japan</td>
<td>0.27</td>
<td>0.54</td>
<td>0.51</td>
<td>0.57</td>
<td>0.59</td>
<td>0.69</td>
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<td>0.68</td>
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<tr>
<td>US</td>
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<td>EU</td>
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<td>0.55</td>
<td>0.52</td>
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<td>0.75</td>
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</tbody>
</table>

Source: Bloomberg, as of 31 December 2018; Correlations are calculated using weekly return in local currency between CSI 300 index and MSCI regional indices from Jan 2014 to December 2018. For illustrative purposes only. All investments involve risks, including loss of principal. We are not soliciting or recommending any action based on this material. Diversification does not ensure against market loss.
Investing with Chinese characteristics

While A-shares offer compelling benefits, the market remains highly inefficient and idiosyncratic. International investors will find vastly different structural and behavioral paradigms at work in China than in most other markets.

Retail investor dominance
An enthusiastic army of retail investors is responsible for over 80% of total trading volume in A-shares. But what is a boon for liquidity can be a bane for market stability; retail investors rely on price momentum, speculation, and headlines rather than fundamentals when making investment decisions and their herd behavior can trigger sudden market movements. Trading activities by large Chinese state-owned institutional investors (the so-called “national team”) can also leave a major footprint on the market.

Trading restrictions
While trading suspensions are a common market-stabilization feature globally, they have been a cause of investor concern in China because of their frequency and duration. For example, on 9 July 2015 the Chinese stock market crashed and volatility reached 60%, with trading of over half of all China A-shares suspended at one point. Trading suspensions can be voluntary or mandatory and can take place for reasons such as company restructuring, change of ownership, or unusual price movements. However, since the peak in 2015, the number of suspensions has dramatically fallen by over 90% by February 2019. Even during the market selloff in the fourth quarter of 2018, suspensions continued their downward trend. Moreover, stricter rules were implemented in November 2018, which included fewer allowable reasons for suspension, greater disclosure, as well as reducing the maximum suspension duration from three months to not more than 25 trading days.

State ownership of listed companies
State-owned enterprises (SOEs) play an outsize role in the Chinese equity market. In terms of capitalization, they dominate highly regulated sectors such as financial, energy, industrial, and utilities. Regulations and policies, therefore, have a significant influence on the business and financial prospects of these companies. A systematic approach that can isolate quality SOEs based on fundamentals or other metrics may offer greater flexibility for investors than market cap-based index investing.

13CEIC, UBS-S, as of 31 December 2018.
14UBS, Why and How to Invest in China’s A-Share Market – From a Quantitative Perspective, 14 May 2018.
15MSCI, as of 28 February 2019, based on full China A-shares universe of over 3,000 securities.
16Shanghai Stock Exchange, November 2018.
Corporate governance and shareholder rights
Unlike the activist role institutional shareholders play in most developed markets, engagements with Chinese companies remain difficult and their outcomes limited. In a recent survey of China-listed companies, a majority of respondents see either a weak or no link between good corporate governance and good company performance.17

Since these anomalies have implications on returns, investors need to consider their investment approach carefully to effectively navigate this market.

Turning anomalies into alpha – systematically
Benchmark allocations tend to offer a shallow and undifferentiated approach to a market whose workings are decidedly different than most other markets in the world. And for the active investor, anomalies represent exploitable opportunities to generate alpha. In the A-share market, we believe a factor-based approach that targets specific stock attributes can offer an efficient and consistent way to sift through market noise and isolate the most compelling alpha opportunities.

Certain investment factors (attributes that are associated with higher returns) behave differently in the A-share market than in other markets, providing opportunity for investors to capitalize on factor-based principles.

Factors Perform Differently in China Than in the US and Hong Kong

Source: MSCI, Wind, FactSet, UBS Quantitative Research, as of 31 December 2018. Long-short USD performance for composite factors from 31 December 2008 to 31 December 2018. Performance for risk is the simple average of performance of low three-, six-, and 12-month volatility and low three- and 12-month beta over their high counterparts. Performance for value is the simple average of performance of high forward book to price, forward earnings yield, forward dividend yield, sales yield, free cash flow yield, EBIT/EV over their low counterparts. For MSCI China A Onshore, the performance for momentum/reversal is calculated as the simple average of performance of low one-, six-, and 12-month price momentum over their high counterparts. For MSCI China, MSCI Hong Kong, MSCI US, the performance for Momentum/Reversal is calculated as the simple average of performance of Low 1m Price momentum, High 6m, 12m Price momentum over their respective counterparts.

This disciplined approach requires access to quality data and real-time information across thousands of stocks. Over the years, increasing data availability across Chinese stocks, bonds, funds, futures, rates, and economic statistics through exchanges, local brokers and private providers such as Wind (China-based), IBES (maintained by Thomson Reuters), Factset, and Bloomberg have allowed active quantitative managers to explore the breadth and depth of the A-share universe.

**Growing Stock Coverage by Private Data Providers**

<table>
<thead>
<tr>
<th>Index</th>
<th>Wind</th>
<th>IBES</th>
<th>Bloomberg</th>
<th>Factset</th>
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</thead>
<tbody>
<tr>
<td>MSCI China A Onshore</td>
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<tr>
<td>CSI 1000</td>
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<tr>
<td>CSI 300</td>
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<tr>
<td>CSI 500</td>
<td></td>
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</table>

Source: Citi, Bloomberg, FactSet, IBES, Wind; as of 31 December 2018. For illustrative purposes only. All investments involve risks, including loss of principal. We are not soliciting or recommending any action based on this material.

Onshore management offers the added benefit of decision making based on an intimate knowledge of China, access to uncommon data sets, and the ability to act timely on emerging opportunities and risks.

**What to consider when choosing a quantitative manager**

When considering an A-share active quant manager, investors may want to seek providers that have a live track record to ensure their model is sufficiently robust to deliver consistent alpha across a variety of market environments. For example, how a strategy performed during the 2015 crash and subsequent recovery period may provide clues to its upside/downside capture ability. Investors should also consider how managers continually innovate their alpha model through market cycles.

Above all considerations, investors need to clearly define their investment objectives, risk/return targets, time horizons, and the role that Chinese equities will play in their portfolios. A comprehensive analysis of the drivers of their portfolios can help avoid over or under diversification, and determine the optimal China equity exposure they need and the appropriate investment vehicle. A nuanced and well-thought-out strategy together with a reliable onshore partner should put the investor on solid footing for the opportunities ahead.

For more information about investing in the China A-shares market, visit pinebridge.com/insights/investment-opportunities/
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