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The Investment Engineers

CHINA

GIVING CHINA ITS RIGHTFUL SHARE IN YOUR PORTFOLIO

Sustainable Investing Expertise by
ROBECOSAM

GIVING CHINA ITS RIGHTFUL SHARE IN YOUR PORTFOLIO

China has been a potent force in financial markets for more than a decade. Its impact on global economic growth has increased markedly. However, international investors own very little of its domestic stock and bond markets. Following major market reforms, main index providers such as MSCI, FTSE and Bloomberg Barclays decided to include Chinese assets with a local listing in their flagship indices. In 2019, we have seen a noticeable increase in the weight of Chinese assets in these indices and further inclusion is likely. The conventional wisdom seems to be that investors will benefit from increasing their holdings of locally listed Chinese assets. Is it time to give China its rightful share in your portfolio?

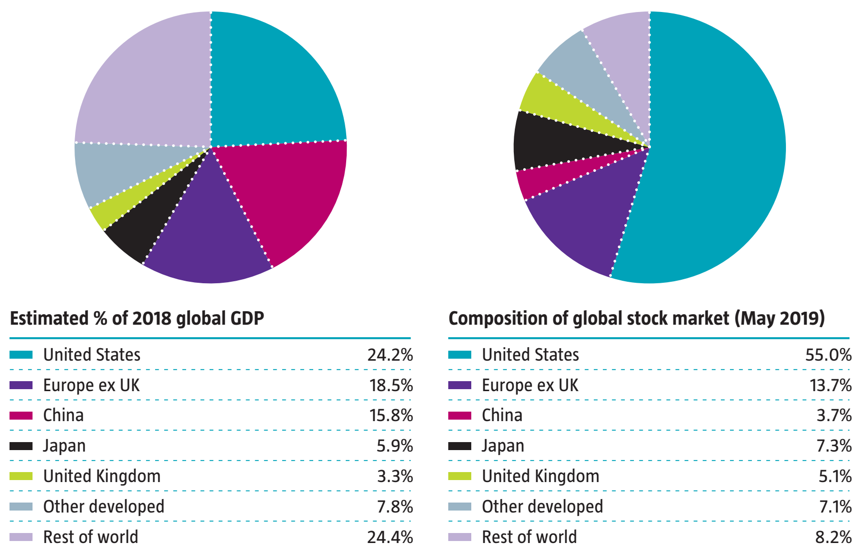
The global multi-asset market portfolio is a good starting point for investors. This is the aggregate portfolio of all investors worldwide, with weights that reflect the composition of the average portfolio. It includes all free-float marketable assets in which financial investors have actually invested. As William Sharpe points out, the portfolio thus represents the optimal portfolio for the average investor. Nevertheless, it does not mean that all – or even any – investors should use it to inform their investment decisions. Investors may want to deviate from this portfolio in the belief that it can be improved. A much-debated deviation is allocation towards emerging markets. But what, if any, are the reasons for deviating from the allocation implied by market capitalization of the global multi-asset market portfolio?

> 'Most international investors have found it difficult to invest in mainland China A-shares'

Shouldn't the weight of China and other emerging markets be bigger by now?

A common argument for increasing the weight of emerging markets or Chinese equities above the weight implied by their free-float market capitalization is the size of the economy. Measured by gross domestic product (GDP), these countries are much bigger than measured by freely floating market capitalization of equities. Figure 1 shows the composition of the global economy on the left and the composition of the freely floating global stock market on the right. It is clear that emerging markets, and China in particular, account for a larger share of the global economy than the stock market. However, there are reasons why this empirical fact should not be the sole reason for investors to allocate more to emerging markets than their market capitalization implies.

Figure 1: The case for global asset allocation



Estimated % of 2018 global GDP

United States	24.2%
Europe ex UK	18.5%
China	15.8%
Japan	5.9%
United Kingdom	3.3%
Other developed	7.8%
Rest of world	24.4%

Composition of global stock market (May 2019)

United States	55.0%
Europe ex UK	13.7%
China	3.7%
Japan	7.3%
United Kingdom	5.1%
Other developed	7.1%
Rest of world	8.2%

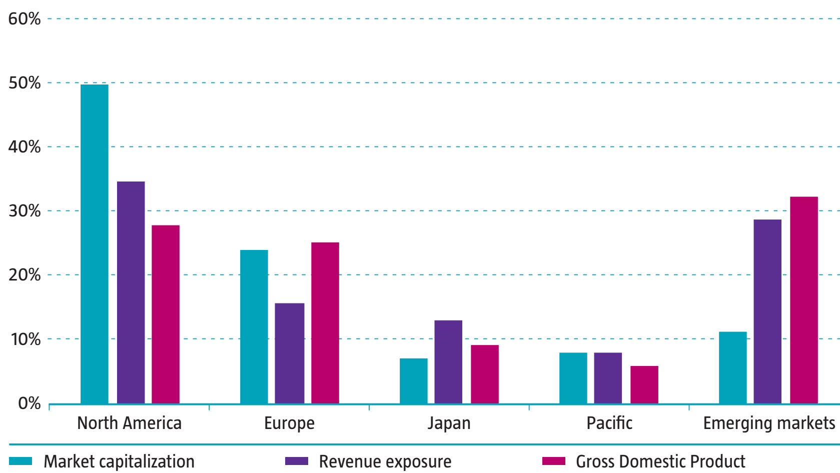
Source: IMF, MSCI, Robeco

The right-hand side of Figure 1 shows the composition of market capitalization by listing location. However, multinational companies are typically listed in the major financial centers in developed markets, such as the United States, but contribute to global economic growth. An example is BMW, which has its primary listing in Germany while its revenues are truly global, with about 20% in 2018 coming from China and only 15% from Germany. This involves not only BMW sales to Chinese customers; the company also produced close to 20% of its vehicles in its Chinese plants in Shenyang. Needless to say, investing in BMW shares offers exposure and contributes to the development of the Chinese economy. This

example suggests that it makes more sense to estimate the geographical composition of revenues for companies in a market capitalization-weighted portfolio to understand their true economic exposure. Based on MSCI Economic Exposures data, Swinkels and Xu (2017)[1] find that the revenue composition is much closer to global GDP than the market capitalization weights suggest. Therefore, an investor with a market capitalization allocation already has economic exposures close to GDP for emerging markets and overweighting is not necessary; see Figure 2.

1. Swinkels, L., Xu, Y., 2017. "Is the Equity Market Representative of the Real Economy?", Economics, Management, and Financial Markets 12(2), pp. 51–66.

Figure 2: Market cap versus revenue exposure



Source: MSCI, IMF (2012), Swinkels and Xu (2017)

As such, the first reason to increase the weight to emerging markets seems flawed. Let's take a look at a second. Emerging markets have a higher growth rate than their developed counterparts, which should lead to higher returns. While this argument sounds valid, some academics argue that the relationship between economic growth and equity returns tends to be negative instead of positive.[2] So, even if emerging markets continue their economic growth path above that of developed markets, there is no reason to believe that this will translate into higher equity returns for emerging markets equity portfolios. Markets already anticipate and have priced in this higher future growth. Therefore, investors need to be able to beat investors' consensus growth predictions to benefit from 'surprise' economic growth. The use of historical economic growth figures has not been a particularly effective means of detecting such surprises, at least not in the past century.

2. See Ritter (2005, 2012) and Dimson, Marsh, and Staunton (2010)

In our view, the reasons discussed are not a basis for deviating from the global market portfolio. Which brings us to the key question: What should we do about China in view of its increasing weight in the indices?

China's weight in indices is bound to increase

International investors have been investing in China for more than a decade. Typically, they invest in Chinese shares listed offshore, for example in Hong Kong. The weight of these shares is quite large in emerging market indices, but still benign in broad indices like the MSCI All Country Index. Most international investors have found it difficult to invest in China A-shares; in other words, Chinese mainland shares. And while the Qualified Foreign Institutional Investor (QFII) program established in 2011 to facilitate foreign investment and its predecessor RQFII[3] allow foreign investment, both cap the amount that can be invested.

3. See the English website of the Shanghai Stock Exchange for more information: http://english.sse.com.cn/overseasinvestors/qfii/intro/

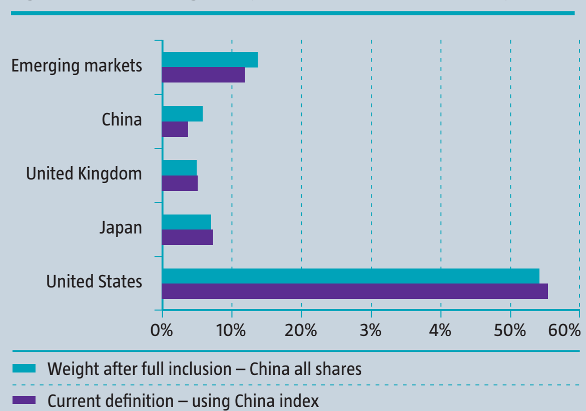
The introduction in 2014 of the Shanghai-Hong Kong Stock Connect – a two-way system between Hong Kong and the mainland indices – has made the China A-share market more accessible for international investors. It allows them to buy China A-shares from Hong Kong, using the Chinese Yuan Renminbi offshore (CNH) currency for their transactions. Unlike the quota schemes, the Stock Connect program provides access to most institutional investors. As a result, the free-float weight of China in the global market portfolio has increased and, unsurprisingly, index providers like MSCI and FTSE have started to include China A-Shares in their indices. Quota, however, still apply. For example, buy orders will be halted if foreign holdings in a given China stock reach 28%.

MSCI and China inclusion

MSCI started to include China A-shares in its indices in 2018. In four steps, it is increasing the weight of these shares. It does so by including a Foreign Inclusion Factor (FIF), which started at 5% and will reach 20% at the end of 2019. The FIF is used to reflect the capacity of the Stock Connect program and the CNH market. The MSCI cites the lack of hedging tools like derivatives as a reason for the incremental increase.

MSCI has previously also used a FIF for Korea and Taiwan. In 1992, the FIF for inclusion of Korean shares in the MSCI indices was 20%. After four years, it was raised to 50% and after six, Korean shares were included fully at 100%. The same might happen to China A-shares. To quantify a full inclusion, we use the MSCI China All Share Index. As MSCI notes: "The index aims to reflect the opportunity set of China share classes listed in Hong Kong, Shanghai, Shenzhen and outside of China. It is based on the concept of the integrated MSCI China equity universe with China A-shares included." The index is broader than the MSCI China index. This MSCI China Index is used in the construction of the MSCI Emerging Market and All Country indices. In Figure 3, we compare the weight of China in these indices based on full and partial inclusion.

Figure 3: China's weight may rise further (MSCI All Country Index)



Source: MSCI, Robeco (May 2019)

Once China is fully included in the indices, it will be the third largest market in the MSCI All Country Index after the US and Japan. The weight of China and the universe of other emerging markets would increase by almost 2% and China's weight in the Emerging Market Index would rise 10% to almost 42%.

Many investors expect China's weight to increase beyond that shown in the table, with some believing it could even overtake Japan as the second-largest market. Based on data from the World Federation of Exchanges, we calculate that the weight may increase to 9%. For this to happen, the size of strategic owners (often the state) needs to come down or there needs to be a wave of Chinese companies seeking a stock market listing.

It is interesting to observe that index providers cap the weight of China A-shares. Yet investors are not bound by this cap. One could argue that investors who follow the global market portfolio should give importance to China based on its unadjusted free-float weight, rather than its index weight. One way or the other, China's share in most portfolios will most likely increase – or are there reasons to expect a different outcome?

Financial economic consequences of further inclusion

Due to the increasing importance of indices in the investment industry, several researchers have investigated the financial economic consequences of changes in index constituents. This research is very relevant, as China's weight is likely to rise.[4] The researchers found a positive effect for shares that are included in emerging market indices. There are two types of price effects: short term and long term. The short-term price effect is typically positive. The demand for a share increases as new investors want or need to allocate to the share following inclusion. This effect is, however, not persistent. After obtaining their desired allocation, the temporary imbalance between demand and supply disappears. One would expect the share to then trade at its fair value again, reversing earlier gains. A more persistent effect, however, can occur when investors assign positive sentiment to the inclusion and thus see it an improvement of the company. For example, a sign that governance is up to par as the company has met the criteria of the index provider. Hence, investors adjust their fundamental value.

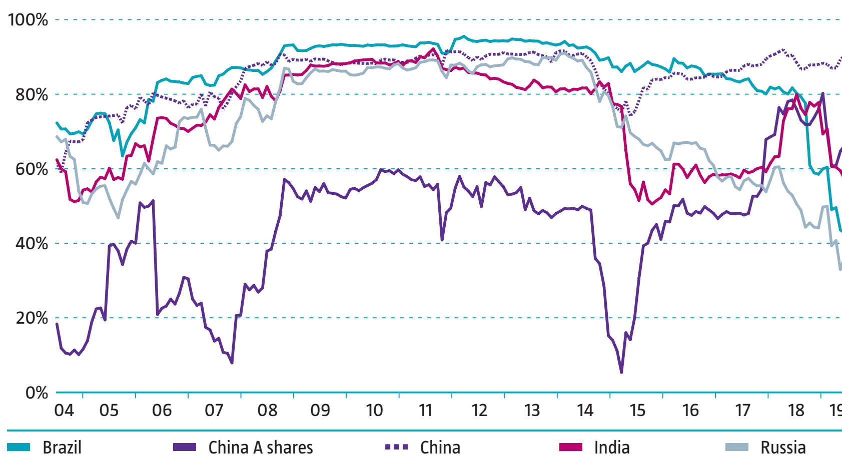
4. Hacibedel and van Bommel (2007) contains a nice overview of the relevant literature.

Short-term price increases for stocks included in the S&P 500 have been documented since the 1980s, and the same effect has been confirmed for international equity markets.[5] So, it is understandable that many asset managers advise clients to invest in China A-shares. However, can we expect a short-term positive effect and subsequent reversal, or will it be more lasting?

5. For example, Harris and Gurel (1986) examined stock inclusions in the S&P 500 Index and Chakrabarti, Huang, Jayaraman and Lee (2005) examined index additions in international stock indices.

Research often notes that China A-shares have unique characteristics that result in a low correlation with other indices. Obviously, this has value for international investors, which would be reason to expect a more long-term effect on the price. In Figure 4, we show the rolling correlations between the BRIC equity markets and the MSCI Emerging Market Index.

Figure 4: Correlations between BRIC countries and the MSCI Emerging Market Index



Source: MSCI, Robeco

As can be seen, the correlation of China A-shares was much lower than that of other BRIC countries until 2015. Following various market reforms, international investors then gained easier access to China A-shares. We can see how the correlation started to increase, which is not surprising. It has been shown that when individual stocks are added to an index, their correlation with other stocks in the index suddenly increases, despite there being no change in the fundamental economic relationship between the constituent companies.[6] Even though correlations between China A-shares and international equity markets may be higher going forward than they have been in the past, there are diversification benefits to investing in assets with a different economic profile.

6. See Barberis, Shleifer and Wurgler (2005).

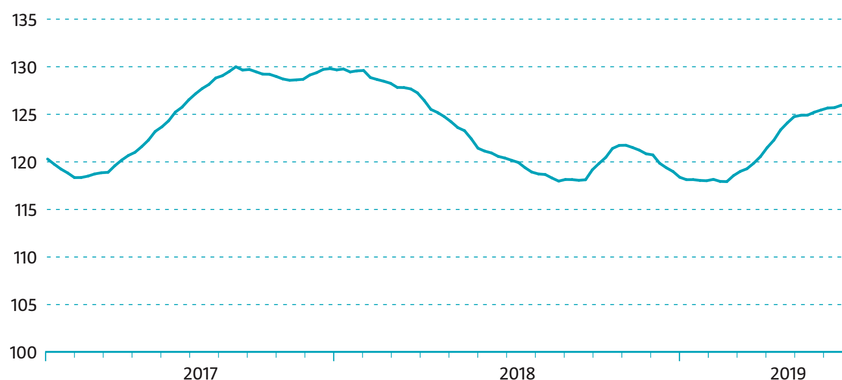
Generally, academics find a positive long-term effect for the inclusion of emerging markets in indices.[7] However, can we expect this to hold for China as well? Our view is that caution is warranted, since the price effect observed for the inclusion of Chinese domestic assets might be lower compared to previous research. One particular reason for this is that index inclusion is discussed and announced well in advance and executed in relatively small steps on each rebalancing date. In such a process, index inclusion provides little new information on the company, so we should not expect positive long-term effects.

7. See, for example, Burnham, Gakidis, and Wurgler (2018) and Hacibedel and van Bommel (2007)

However, one reason to expect a positive long-term effect is that international investors are willing to accept lower returns than domestic investors. Where domestic investors are restricted to investing in only in the domestic market, they cannot benefit from international diversification. In contrast, international investors can benefit from this diversification and therefore may be willing to pay a higher price, as their total risk will be lower than that of domestic investors. As investors in China fall into the former category, one would expect China A-shares to trade at a discount (i.e. investors demand a higher return). In practice, we have witnessed the opposite. China A-shares that are also listed in Hong Kong have tended to trade at a premium in the domestic market, as shown in Figure 5. The Hang Seng Stock Connect China AH Index Series measures the absolute price premium (or discount) of A shares over H shares for the largest and most liquid mainland Chinese companies with both A-share and H-share listings.[8]

8. See, https://www.hsi.com.hk/eng/indexes/all-indexes/ahpremium

Figure 5: Hang Seng Stock Connect China AH Premium Index (10-week moving average)



Source: Bloomberg, Hang Seng Stock Connect

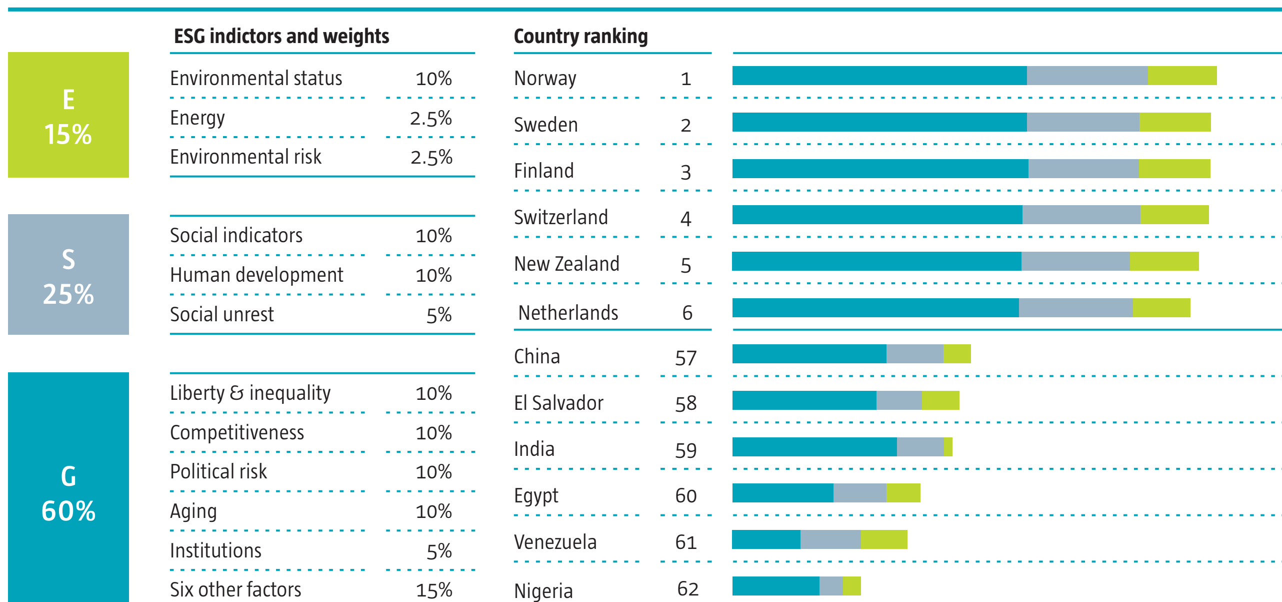
Other consequences of further inclusion

Like other emerging market countries, China's sustainability score is relatively low compared to developed markets. Figure 6 shows part of RobecoSAM's country sustainability ranking, which is based on 17 indicators: three environmental with a weight of 15%, three social with a weight of 25% and 11 governance with a weight of 60%. The score ranges from 1 to 10, 1 being the lowest and 10 the highest. The country sustainability ranking shown here is used to provide investors in government bonds with relevant ESG information. China's score is at the bottom of the table. It is low but the same is true for the other BRIC countries. The key difference with other emerging markets is the size of China's financial markets. When sustainability risks are country-specific, they can be diversified away in global portfolios. However, for large financial markets, country-specific risks can only be partially reduced by international diversification. So, government bond investors that have an ESG policy are likely to face stumbling blocks as China's ESG challenges become too big to ignore.

The sustainability ranking is primarily of interest to government bond investors. However, China's political and institutional risks may also affect equity and corporate bond investors. China's recent policy has been to open up its financial markets to foreigners. Yet this could reverse in the future and, given the country's relatively high political risks and relatively weak institutions with respect to shareholder protection, how sure can investors be that they will be allowed to sell their assets when they want?

To prevent large idiosyncratic default risks, fixed income indices typically cap the weight of individual issuers, which could be a prudent course of action for Chinese government bonds as well. Setting a cap for the country weight of China might also be a solution in the case of equities and corporate bonds – to take into account the political and institutional risks also affecting these asset classes.

Figure 6: How does China score on country sustainability?



Source: RobecoSAM, https://www.robeco.com/en/key-strengths/sustainability-investing/country-ranking/

Giving China its rightful share?

We believe that the global market portfolio is a good starting point for investors as it still holds a relatively small weight for China that is likely to grow going forward. Should investors act on this expected growth? Our analysis contains some of our thoughts on the answer. In particular, we looked at compelling arguments to give China a larger share in portfolios. We believe that the arguments do not hold, or that they are disputable. Furthermore, a significant larger allocation to China would likely be detrimental to the ESG profile of most portfolios. In our view, the best approach would be to gradually increase allocation to China as the country continues to improve its governance and market reforms. It is important to set your own pace and keep an eye on valuations; as most index providers adopt a similar inclusion approach, investors run the risk of a reversal of the short-term positive price effect following index inclusion. Fortunately, China A-shares currently still represent only a modest part of global equity market indices, so investors have time to make up their minds about the benefits and challenges of increasing their allocation.

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