



Theme: China A Shares

NOVEMBER 2023

Overview

China 'A' shares represent Chinese companies listed on mainland China exchanges, primarily in Shanghai or Shenzhen. It is the second-largest equity market globally with a total capitalisation in excess U\$10 trillion, making it second only to the United States.

Yet despite its vast size and potential, the China A market often flies under the radar. It is typically under-owned, unloved and often trades at undervalued multiples. We believe these traits make for an interesting investment proposition.

China stands as the world's second-largest economy, boasting a formidable U\$18 trillion GDP, and certain forecasts suggest it may surpass the United States (currently a U\$23trn economy) before 2050.

Despite its economic status and significant global influence, China remains notably underrepresented in capital market benchmarks. For context, mainland Chinese stocks constitute a mere 3% of the MSCI AC World index, despite accounting for a substantial 18% of the world's GDP. This disparity leaves global investors significantly underexposed to such an influential market. Currently, foreign ownership of China A shares remains below 5%, in stark contrast to developed markets like Japan, where overseas investors drive around 30% of demand.

However, the ownership structure is undergoing a notable transformation. Leading global index providers have been progressively increasing China's presence in their benchmarks, leading to a substantial influx of international capital. A significant milestone in this process was the successful launch of the Stock Connect program, which fostered connectivity between Hong Kong and mainland China back in 2014.

As a result of these developments, China A shares are now included in global benchmarks, albeit at a scaled-down weight of 20% within the Emerging Markets allocation. It's important to note that this is an initial allocation and, over time, we anticipate further increases as China's financial markets continue to mature. A parallel story has unfolded with Chinese bonds, mirroring a similar path toward inclusion in international portfolios.

The valuation of China A shares has shown significant volatility over the past two decades, featuring euphoric blow-off peaks and extreme troughs. This underscores the

influence of investor sentiment in shaping both bull and bear market trends. History suggests low valuations and downbeat investor sentiment often pave the way for robust market gains. Conversely, elevated valuations and exuberant sentiment tend to precede major downturns.

The China A shares market also offers an attractive source of diversification. In part, this is because of the relatively low participation of international investors. In recent years, China's economic growth and inflation trends have diverged from other major economies, which has also been a key factor. This means China A shares can be a useful portfolio diversifier as well as a generator of attractive returns.

In essence, the China A shares opportunity can be summarised as follows:

- **What?**
Mainland Chinese large-cap equities
- **Why?**
Structurally under-owned, but that is changing and they are a good diversifier
- **How?**
China A equities ETF
- **Holding Period?**
3yrs+

Delving into some more detail...

What do we mean by China 'A' shares?

Chinese companies can list shares in several different locations:

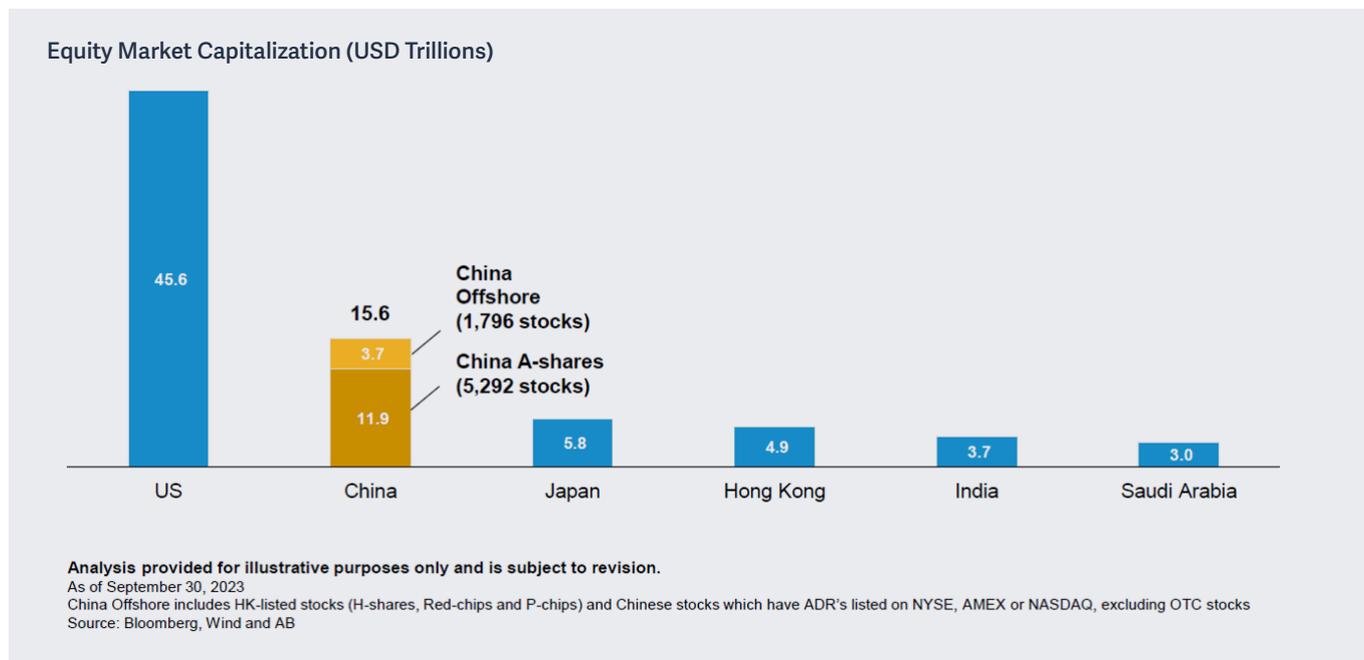
- Mainland China on a domestic exchange (A shares)
- Hong Kong (H shares)
- America (ADRs, or American Depositary Receipts)



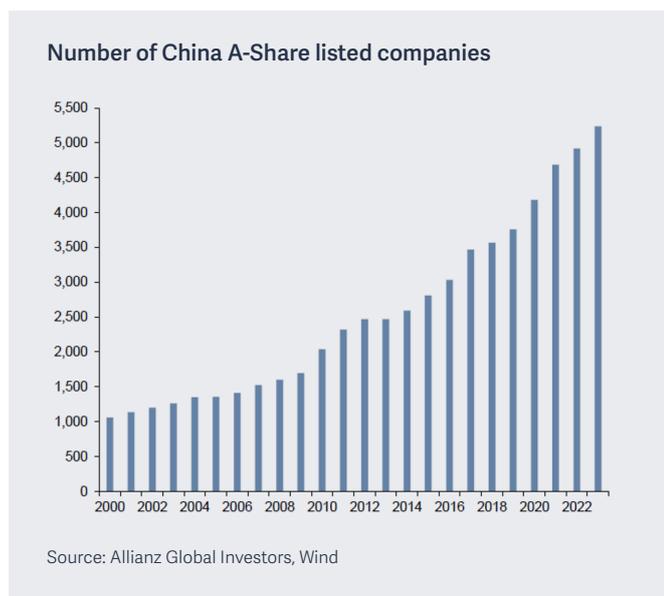
	Shenzhen A-shares	Shanghai A-shares	China Stocks listed in HK	US-listed ADRs	Total
Market cap (USD tn)	4.6	6.8	3.6	0.8	15.8
Number of stocks	2,805	2,226	1,432	155	6,618

Source: Allianz Global Investors

China A shares represent companies listed on the Chinese mainland (on the Shanghai and Shenzhen exchanges). It is a relatively new market and until recently has been closed to foreign buyers. It is a broadly diversified index of over 5,000 companies with a combined market cap of over U\$10 trillion, making it the second largest market in the world (behind the United States). It is the biggest stock market many people have never heard of.

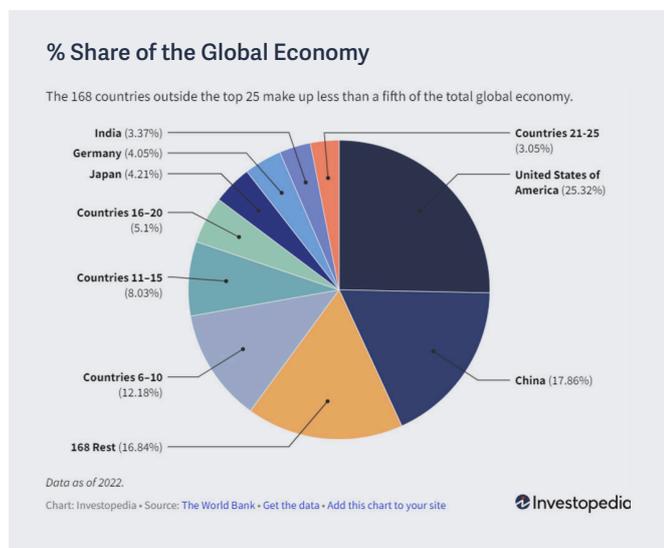


Over the past two decades, the number of companies listed on Chinese domestic exchanges has surged from 1,000 to well over 5,000. This stands in stark contrast to the major Western markets where “de-equitisation” has been the dominant trend. It ensures China A shares offer a good representation of the broader economy, which is particularly relevant with new businesses and industries being birthed by China’s push to modernise. It also means the stock market is becoming deeper and more liquid.

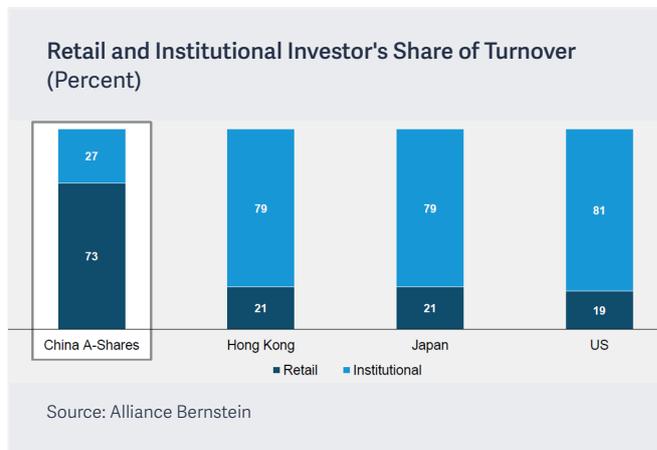


Investors are underweight China

China's presence in capital market benchmarks is limited. While the country accounts for a substantial 18% of the global GDP, as illustrated in the pie chart below, it comprises a mere 3% of the MSCI AC World equity index. Even a modest increase in this market share could result in significant share price gains.

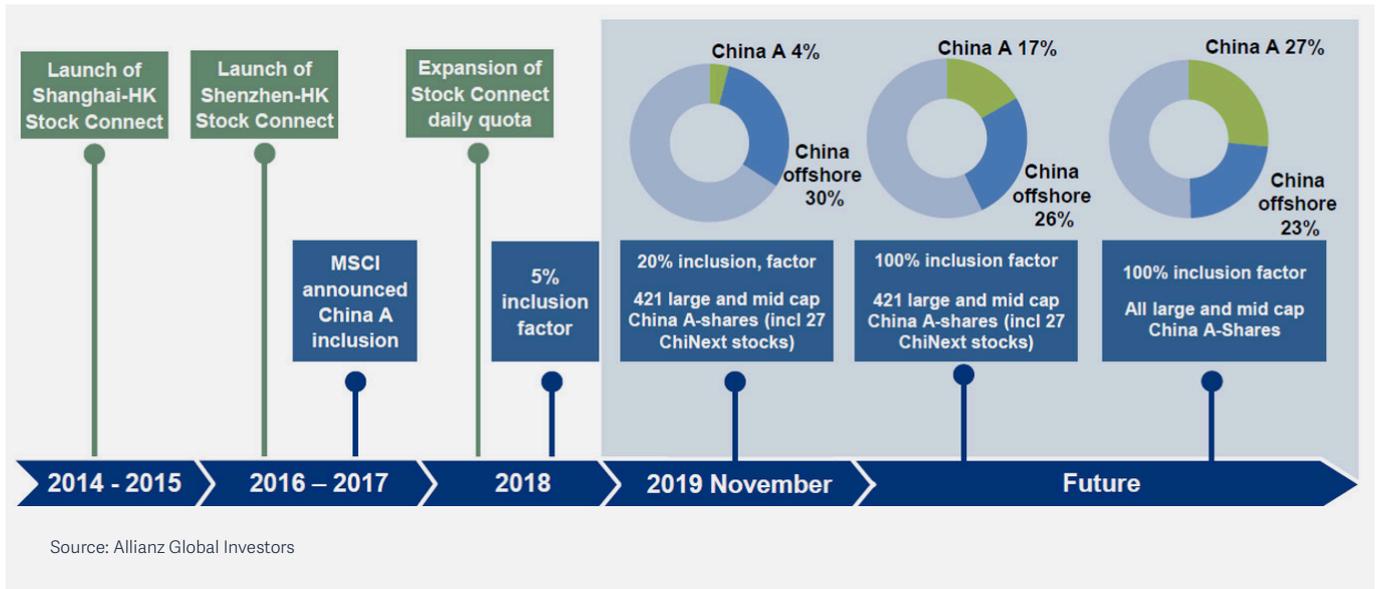


Unlike many other developed world stock markets, the China A shares market is still dominated by retail investors, which leaves it prone to wilder swings on the up and downside. However, institutional investor ownership has scope to expand meaningfully over the coming years.



Chinese authorities have taken measured steps to open up their domestic A shares market to foreign investors. This initiative began with the Qualified Foreign Institutional Investors (QFII) scheme in 2002, shortly after China's accession to the WTO in December 2001. Another key development was the introduction of the Stock Connect program between Hong Kong and mainland China in 2014, which significantly expanded access for foreign investors.

Subsequently, MSCI made a pivotal announcement, stating its intention to include China A shares in the MSCI Emerging Markets (EM) index. Rather than add China A shares at a full weight based on their market capitalisation, they used a scaled down allocation known as the ‘inclusion factor’ to gradually add the companies into their benchmarks. This was initially set at 5% of market capitalisation, but has since increased to 20%. China A shares now constitute 5% of the broad EM index. This marks a significant presence that looks set to grow more dominant over time.



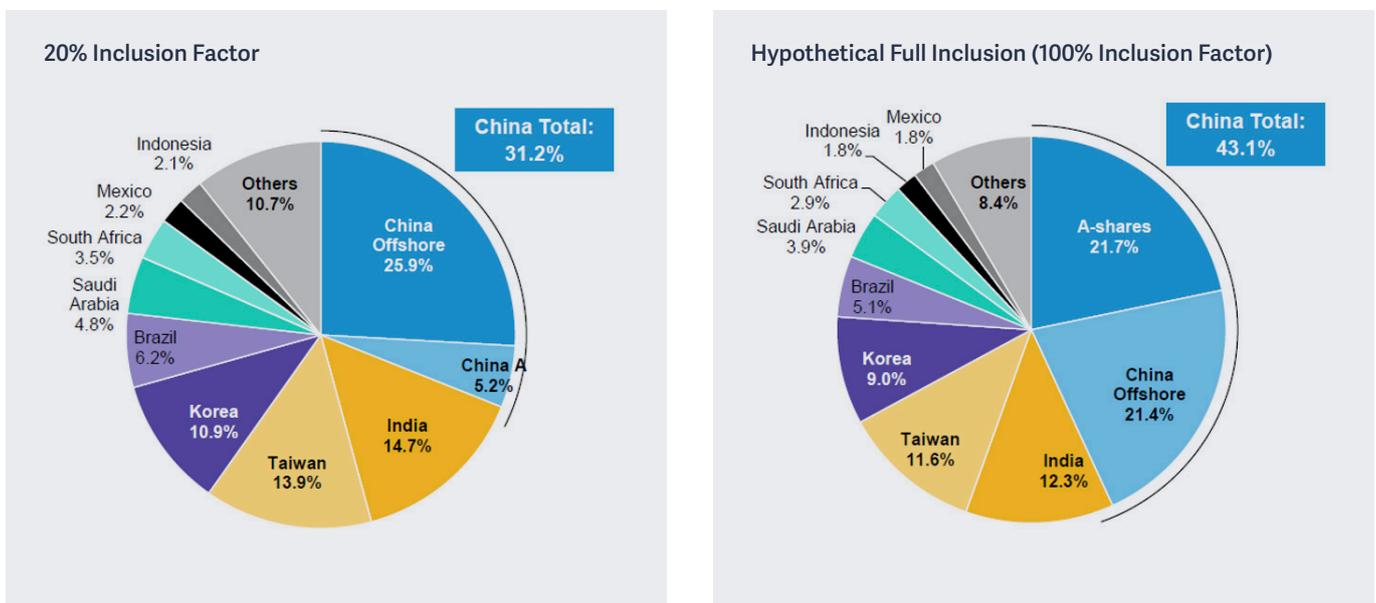
At the time, MSCI commented:

“In 2019, MSCI increased the inclusion ratio of China A shares from 5% to 20% in the MSCI Emerging Markets Index. Investors globally are now increasingly re-evaluating the appropriate allocation framework of their equity portfolios. China’s growing economic strength and improving market accessibility may transform the characteristics of the emerging-market asset class and its role in global portfolios.” (source: MSCI.com)

MSCI outlined areas that need addressing by the Chinese regulator CSRC (China Securities Regulatory Commission) before they further increase the inclusion factor:

- Access to hedging and derivatives to permit better risk management
- Extend the settlement cycle to T+2 as the short settlement period causes issues
- Align trading holdings between onshore China and Stock Connect
- Create omnibus trading mechanism in Stock Connect

A hypothetical full inclusion factor at 100% would see China A shares grow to over 20% of the MSCI Emerging Markets index compared to today’s 5% weight, as the pie chart below demonstrates.



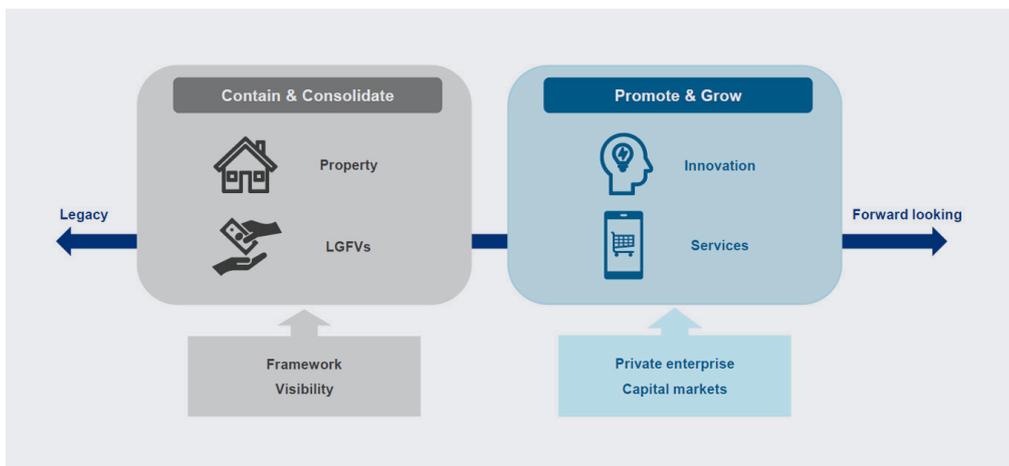
Given this direction of travel we believe global investors are significantly underweight domestic Chinese stocks. Foreign ownership of the China A share market is estimated at under 5% of total market cap. In developed markets such as Japan, the comparable figure is closer to 30%. In short, structural buying is likely to be a significant tailwind for mainland China stocks over the coming years and that should ultimately lead to higher share prices.



Source: Ninety One

Why does China need foreign capital?

President Xi has shown a commitment to addressing specific societal challenges through periodic crackdowns on sectors such as steel mills, food companies, banks, pharmaceuticals, technology, private education and, more recently, property developers, but China's strategic long-term ambitions are fundamentally anchored in maintaining access to foreign capital. Regulators clearly understand the significance of well-functioning capital markets and a more 'internationalized' currency as pivotal tools that will assist the authorities in realising their objectives. They realise that capital markets can help promote economic growth and job security.



Source: Allianz Global Investors

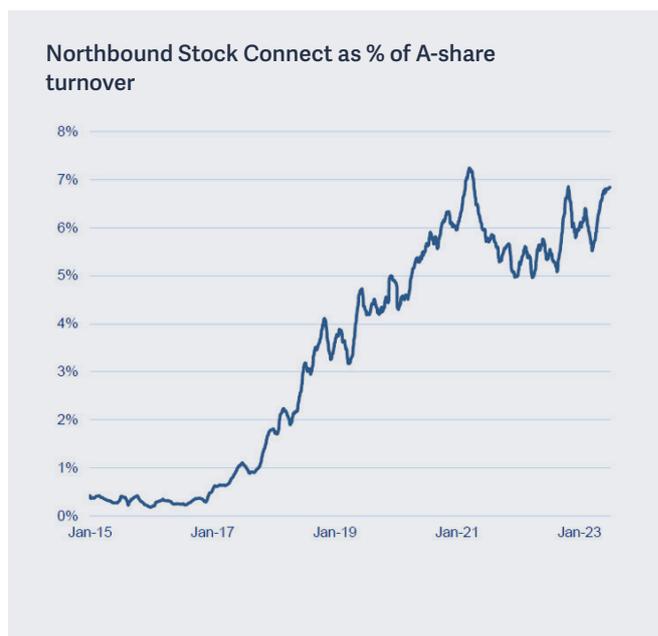
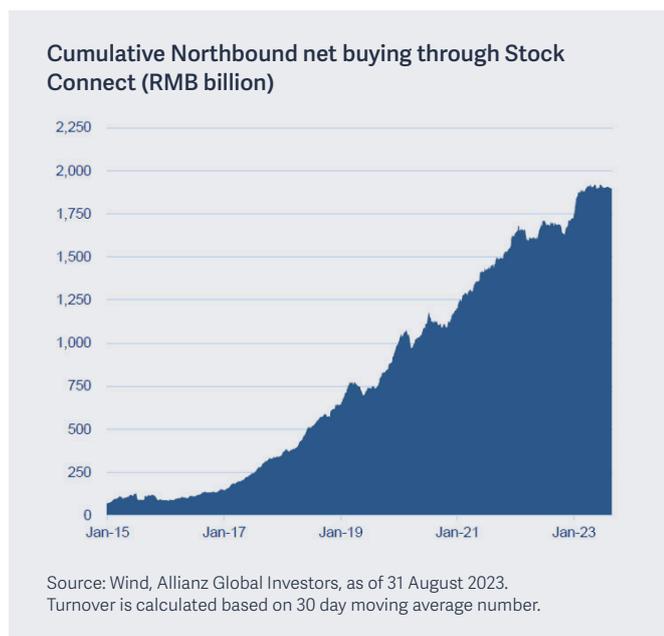
Taking this a step further, a number of China A listings represent companies (and wider industries) that are direct beneficiaries of the government's drive to modernise the economy. The top 10 stocks in the iShares MSCI China A ETF include consumer names such as Kweichow Moutai and Wuliangye Yibin, battery technology firm Amperex, Electric Vehicles (BYD) and medical equipment (Mindray). These companies are well positioned to capture secular earnings growth over the coming years and decades.

Issuer Ticker	Name	Sector	Asset Class	Market Value	Weight (%)
600519	KWEICHOW MOUTAI LTD A	Consumer Staples	Equity	USD 131,535,591.95	5.99
300750	CONTEMPORARY AMPEREX TECHNOLOGY LT	Industrials	Equity	USD 49,286,600.06	2.25
600036	CHINA MERCHANTS BANK LTD A	Financials	Equity	USD 36,904,371.16	1.68
000858	WULIANGYE YIBIN LTD A	Consumer Staples	Equity	USD 35,965,197.88	1.64
600900	CHINA YANGTZE POWER LTD A	Utilities	Equity	USD 31,990,954.53	1.46
601318	PING AN INSURANCE (GROUP) OF CHINA	Financials	Equity	USD 28,073,053.50	1.28
002594	BYD LTD A	Consumer Discretionary	Equity	USD 25,120,267.96	1.14
300760	SHENZHEN MINDRAY BIO-MEDICAL ELECT	Health Care	Equity	USD 20,358,458.47	0.93
000568	LUZHOU LAO JIAO LTD A	Consumer Staples	Equity	USD 18,663,331.25	0.85
601166	INDUSTRIAL BANK LTD A	Financials	Equity	USD 18,385,467.93	0.84

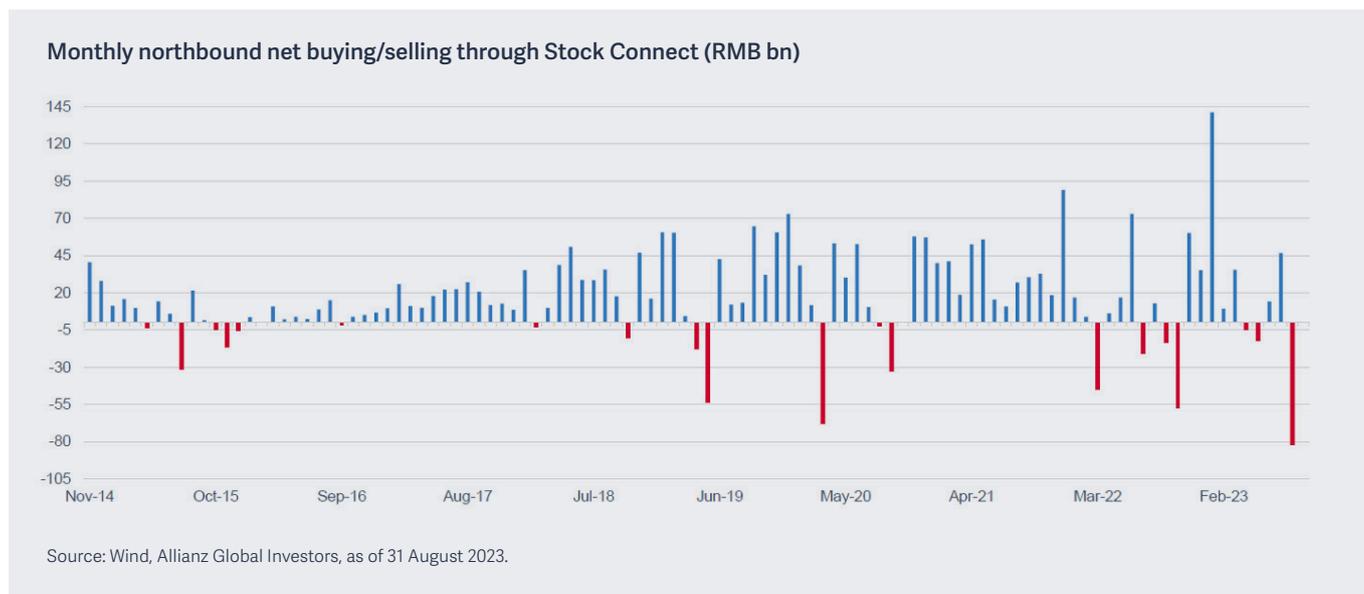
Source: BlackRock, Nov '23

Investor Flows

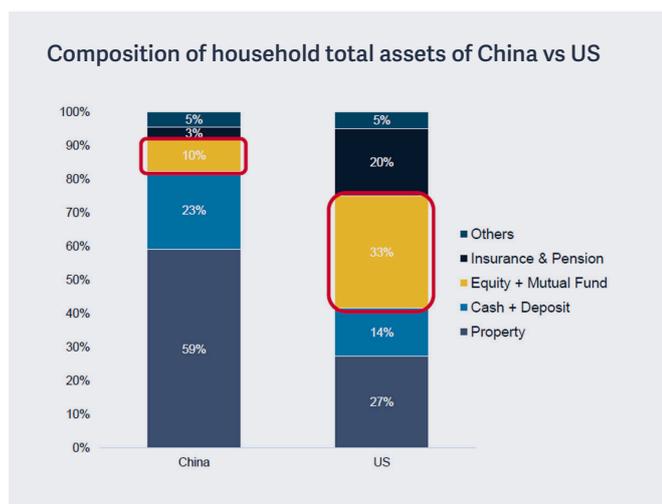
Foreign investors have been actively participating in mainland stock markets through the Stock Connect program. Northbound flows in this context refer to overseas investors, including those from Hong Kong and abroad, trading eligible China A shares. The chart on the left shows the rising cumulative trade volume since the program's launch in 2014. Furthermore, as illustrated in the right-hand chart, Stock Connect flows have been steadily increasing as a percentage of total China A-share turnover.



Similarly, the monthly net buying figures through Stock Connect, shows consistent positive monthly flows into mainland Chinese stocks with only a few isolated months of outflows. This adds weight to the argument that foreign investors are becoming a more influential driver of demand.

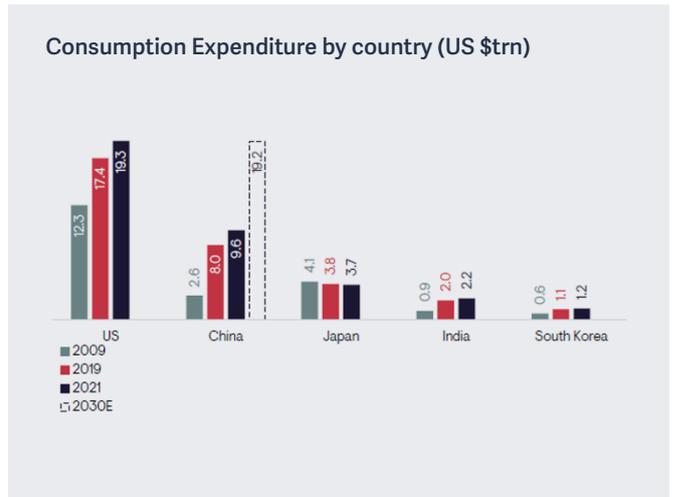
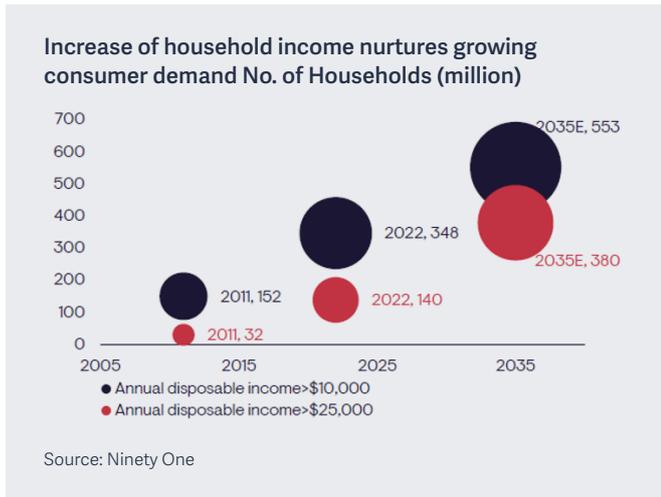


Chinese households also have significant room to add to equities as the population ages and becomes wealthier. Equities represent just 10% of household assets, compared to 33% in the US.



Source: Allianz Global Investors

Looking at the bigger picture, the Chinese consumer market is poised to double in size over the next decade, driven by the prospect of 380 million households reaching a U\$25,000 income level by the year 2035. This should magnify the positive “flow” effect into Chinese equities over the coming years.



Valuation

The valuation of China A shares has varied dramatically over time.

The price/book multiple is one of our favoured ratios for judging the valuation of Chinese A shares because, historically, it has helped us to identify important turning points. Simply put, when the P/B ratio falls to 1.5x or lower (red circles below), it tends to infer high returns over the next few years.

Conversely, a P/B ratio well above 3x has warranted caution. However, it's essential to note that while valuation is an important aspect, it should not be the sole tool for timing entries and exits. Therefore, we complement our valuation analysis with a broader assessment of economic and liquidity conditions.

As of late 2023, the P/B ratio was oscillating around 1.3x, firmly in the buy zone.

SHCOMP price and P/B ratio (blue)

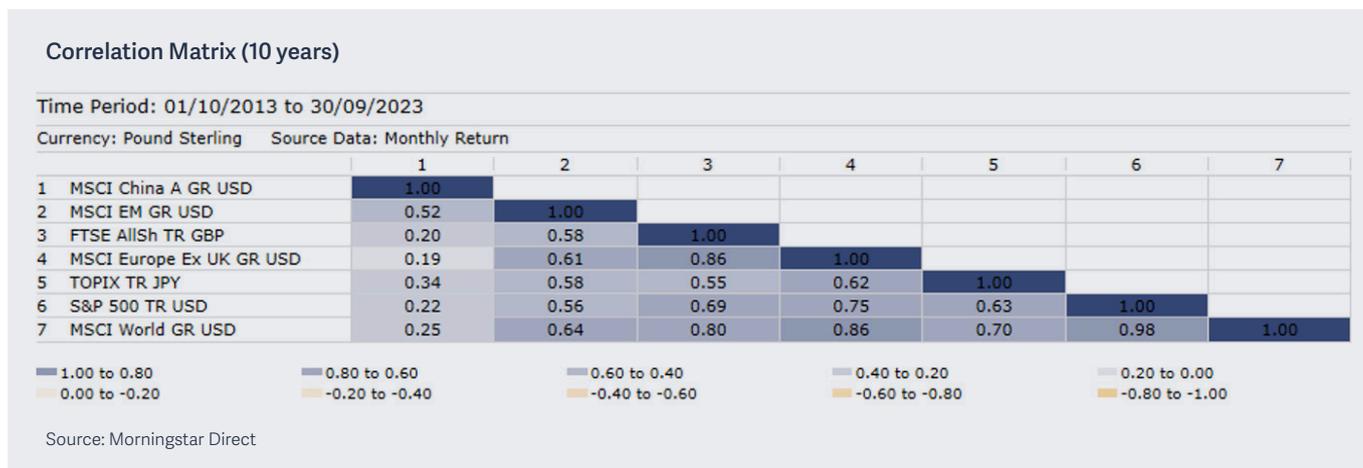


Comparing the China A price/book ratio to the broader MSCI World index can also be a useful exercise. A lower multiple versus its peers reflects an additional valuation cushion for China A shares (and vice versa).

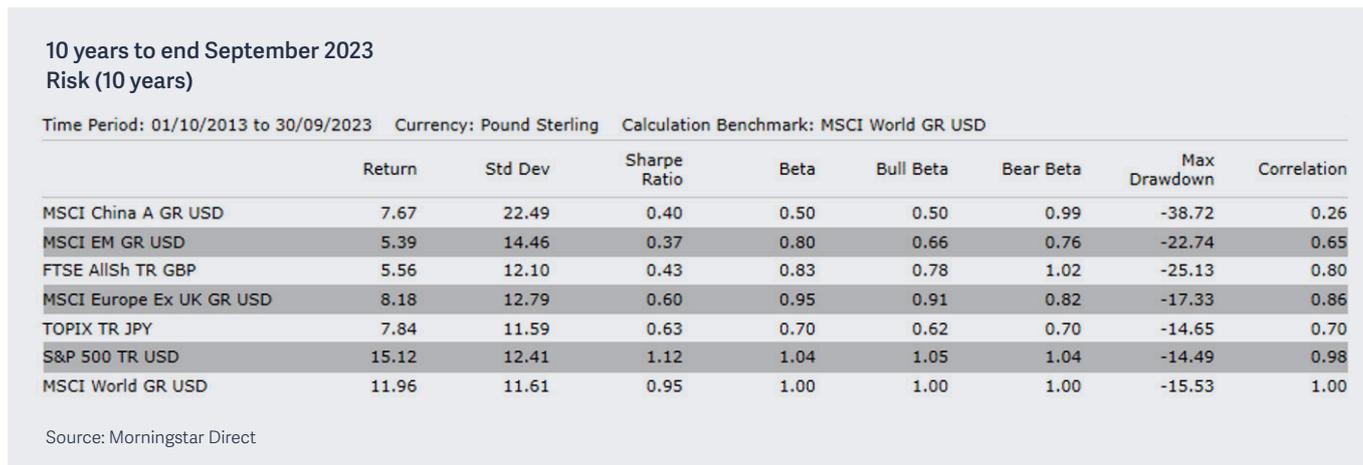
Diversification through China A shares

Another benefit of investing in China A shares is their ability to diversify portfolios. This diversification arises from a combination of factors including the limited participation of international investors and the more recent variations in economic conditions, including divergent inflation trends and monetary policies. Consequently, this market tends to exhibit a low correlation with other global markets, making it a valuable allocation from a risk management perspective.

As demonstrated in Column 1 of the table below, China A shares have displayed a very low correlation with the likes of US, UK, European and Japanese equities over the past decade. Notably, the correlation with the MSCI World stands at just 0.25.

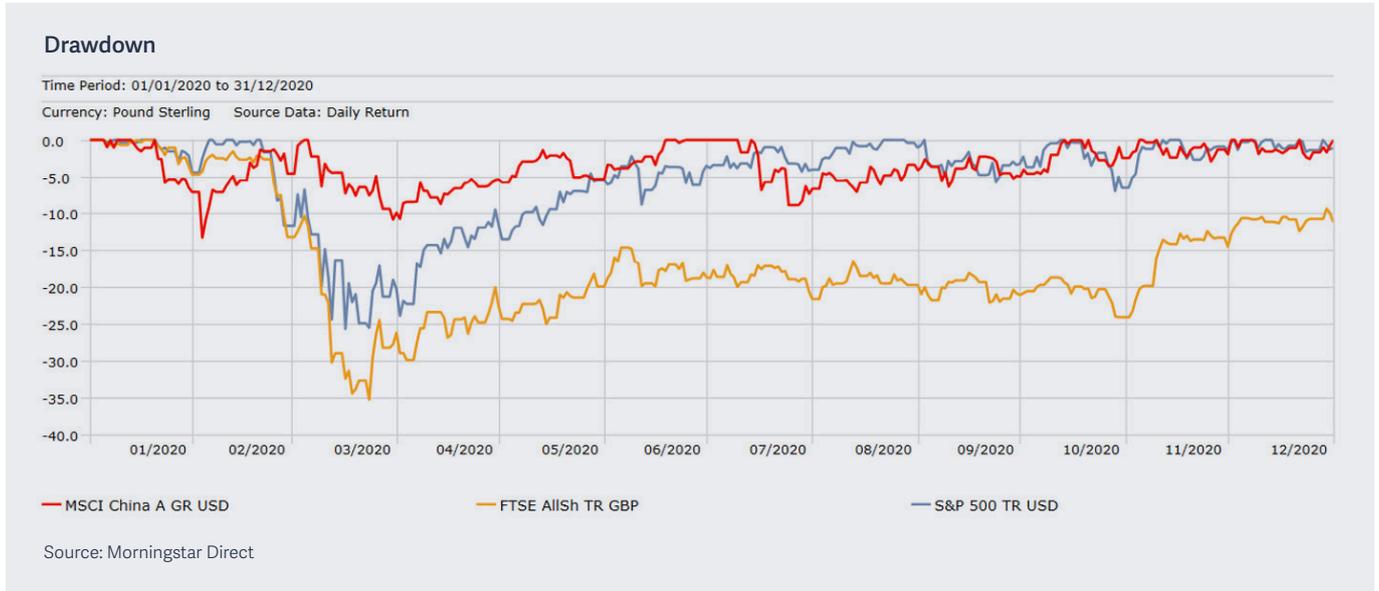


From a returns perspective, the MSCI China A index has delivered superior returns over the past decade compared to a broad Emerging Markets index. It has also outperformed some developed markets, such as the FTSE UK All Share (see table below). While its performance has been in line with European and Japanese indices, it has (like most regional indices) lagged behind the exceptionally strong U.S. stock market.



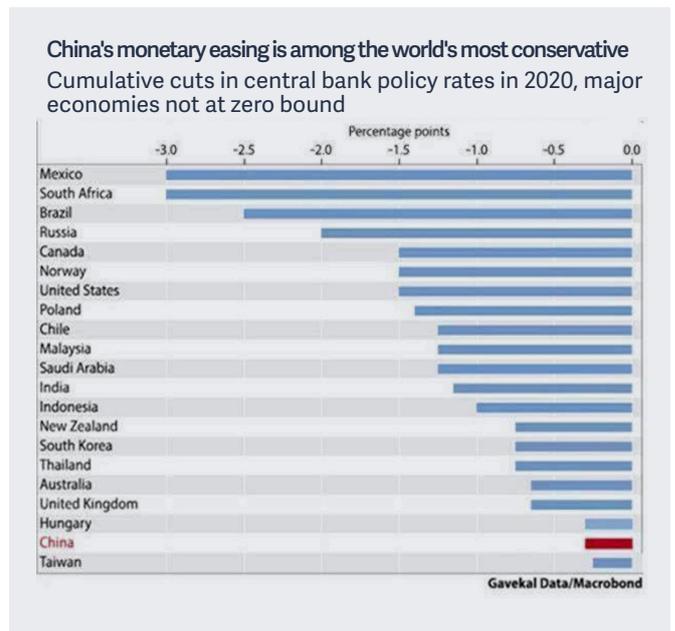
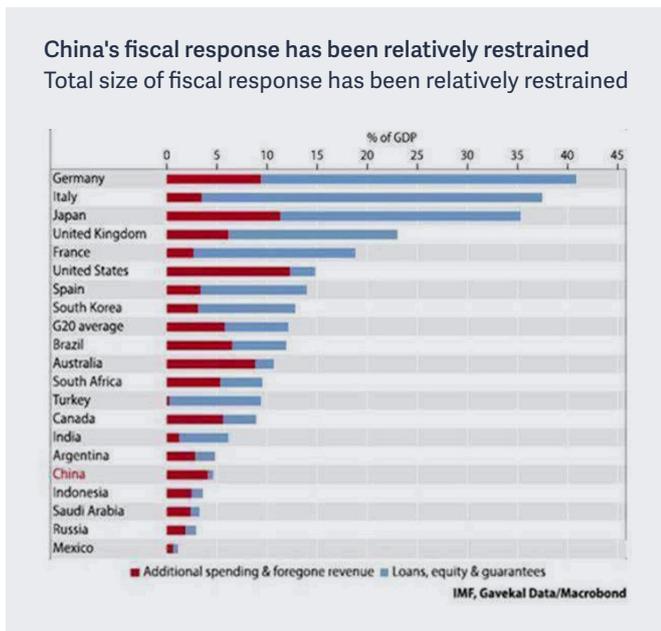
What about Drawdowns?

Another perspective on the diversification benefits of owning China A shares is to consider their drawdown profile, which quantifies the downside risk during market declines. An illustrative example of this occurred during the Covid-19 lockdown period in 2020 when global equity markets faced a significant downturn. China A shares (indicated by the red line in the chart below) demonstrated remarkable resilience and were amongst the best-performing regional markets. This outcome can be attributed to differing Covid-19 policies and policy responses. Notably, China A shares experienced significantly smaller drawdowns compared to UK stocks (orange) and even the US market (blue).



What about Liquidity?

The Chinese authorities possess several instruments to address any liquidity concerns and often provides support to equity markets during periods of weakness. Notably, the People's Bank of China (PBoC), the central bank of China, has been among the more conservative responders to the challenges posed by the pandemic. Research firm GaveKal has observed that China's fiscal and monetary responses were amongst the most restrained.



Examining the monetary response first, M1 (a narrow measure of the money supply encompassing currency, demand deposits and other liquid deposits, including savings deposits) has been growing at a subdued rate since the pandemic, as indicated by the orange line in the chart below.

However, over the long term, the Chinese stock market has often performed favourably during periods of monetary policy easing. Notably, the equity market tends to thrive when authorities expand the monetary base, as was witnessed most recently from 2018 to 2020.

SHCOMP vs China M1YoY (1994-2023)

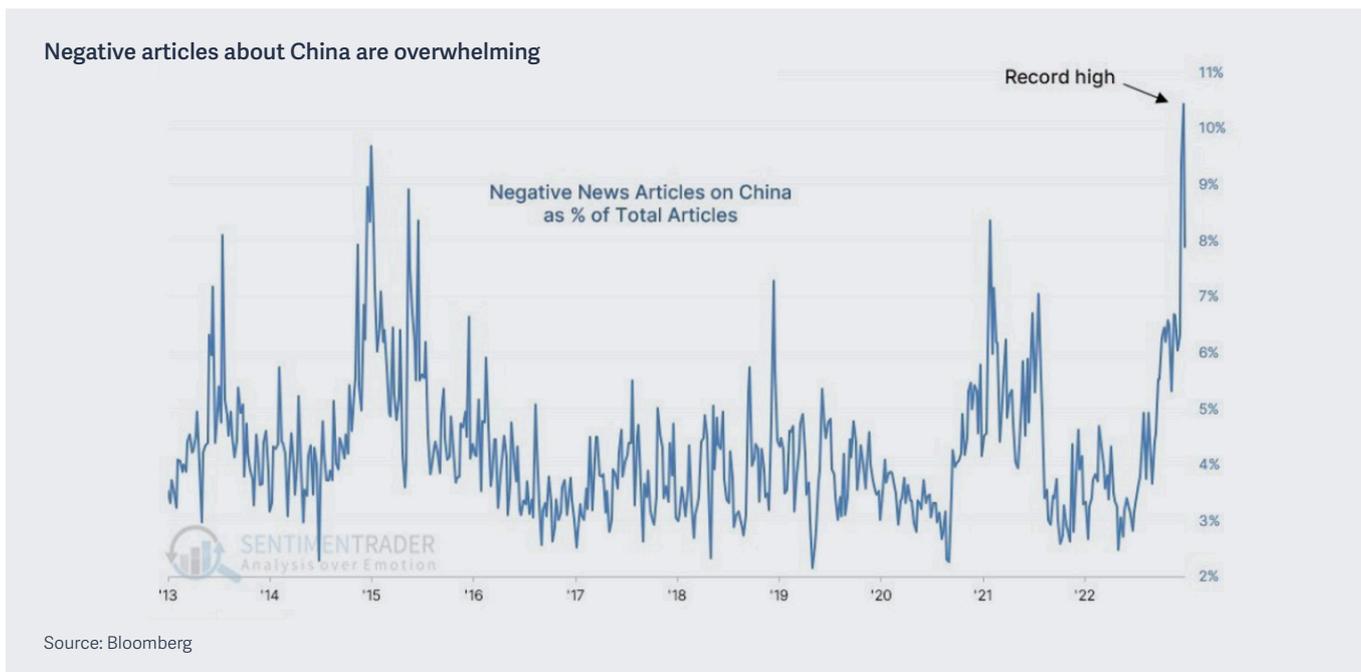


In short, Chinese equities tend to be well supported whenever the PBoC is taking measures to enhance liquidity conditions.

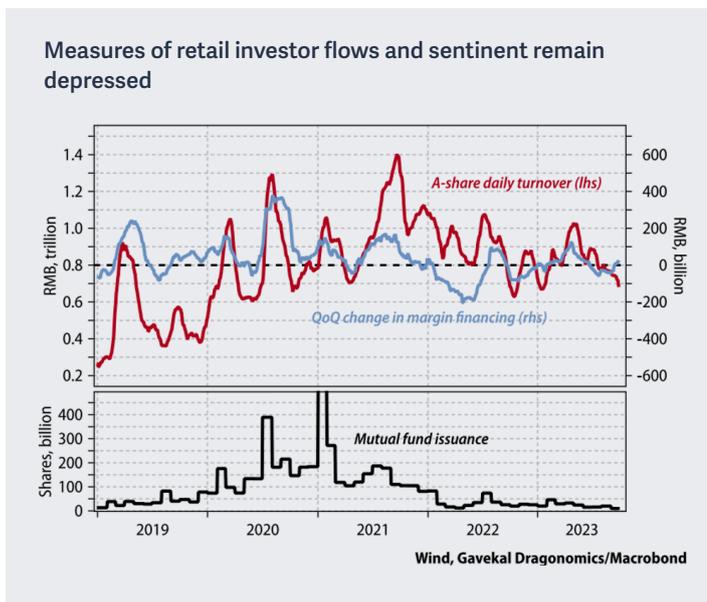
Tracking Sentiment & Positioning

As previously mentioned, the Chinese stock market is often characterized as “momentum-based”. While valuations and economic fundamentals can offer valuable signals regarding the next major market pattern, other tools can be employed to gauge the catalyst for a potential trend reversal.

Monetary and fiscal policy intentions, for instance, usually serve as a dependable guide with China A shares more likely to rise than fall when policymakers are actively providing support. Additionally, sentiment extremes can prove to be valuable timing indicators; prior spikes in negative news articles typically coinciding with major market troughs (and vice versa).



Major market bottoms also tend to coincide with weak retail investor flows and low levels of margin financing. The converse is true when a major market peak is likely approaching.



And, finally, the front cover of the Economist magazine is often a helpful contrarian indicator (for good or bad).

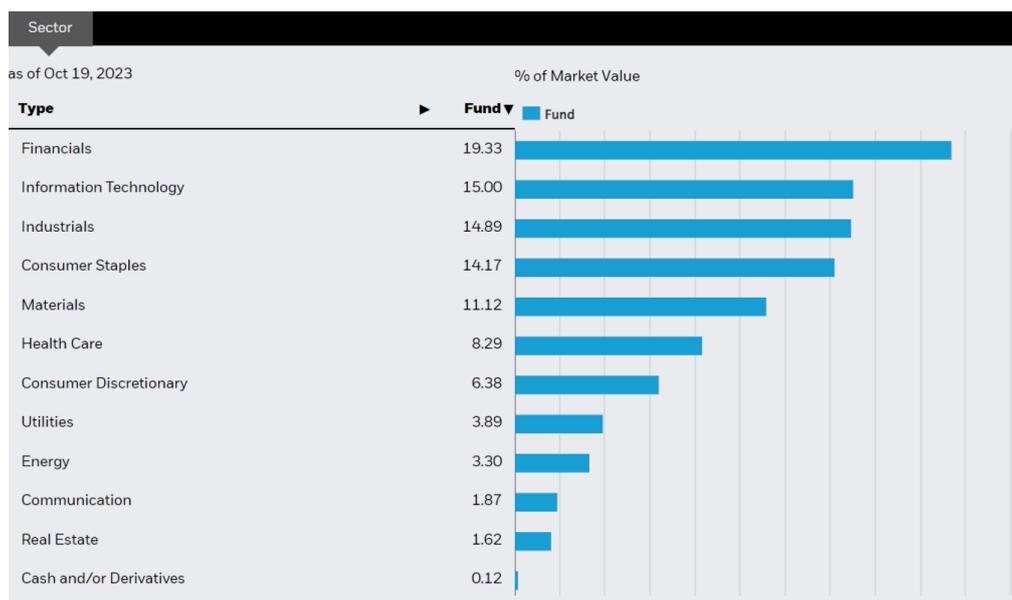


Active vs passive investing

Historically, we have utilised both active managers and passive (index-tracking) funds to populate an exposure to China A shares. Our approach involves closely monitoring measures of outperformance and underperformance of the active fund relative to the broad China A share market to determine the suitability of a passive allocation.

Currently, we have chosen to invest in the iShares MSCI China A ETF, which tracks the index performance of the MSCI China A inclusion benchmark.

This ETF is sizeable with assets exceeding US\$2 billion. Its Total Expense Ratio (TER) stands at just 0.4%, approximately half the cost of an equivalent actively managed fund. It owns 557 stocks so represents a broad market opportunity and it is well-diversified across both sectors (see chart below) and individual stocks. The largest holding is white liquor manufacturer Kweichow Moutai with a 5% position size, while most other stocks have weights of less than 2%



Source: BlackRock iShares

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