



The Case for Greater China Exposure in Global Equity Portfolios

Q1 2020



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China has rapidly become the second-largest economy in the world and has been the key driver in global growth over the past decade, yet it remains woefully underweight in global investors' portfolios by nearly any measure. As China has come to the forefront of investors' minds, and has become a larger portion of global indices over the past several years while dominating global headlines, both positive and negative, investors have been slow to catch up to today's global balance. We believe this slow reaction to the rise of China as a global economic power creates an opportunity for investors who are willing to lead the pack.

The opportunity comes not only from the early adoption in advance of increased global index exposure, but also from valuations today compared to global equities and the potential for a multiple rerating as the Chinese equity market develops and becomes more institutional in its makeup. In the following pages, we will:

- ✿ look at what makes China a compelling, stand-alone investment opportunity in our view
- ✿ compare the various means of gaining exposure to China
- ✿ examine the case for a dedicated allocation to China today
- ✿ demonstrate why a flexible, active-management approach is an optimal method for harnessing this opportunity.

Investments involve risk. Past performance is no guarantee of future results. Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation.

FOR INSTITUTIONAL/PROFESSIONAL INVESTORS ONLY



Part 1—Why China Now

- ✿ The Chinese market is second only to the U.S. in breadth, depth and liquidity, yet it is an afterthought in global benchmarks.
- ✿ Chinese equities have been a driver of long-term alpha for emerging markets strategies.
- ✿ Many investors are underweight in their exposure to global emerging markets.

HOW CHINA IS ACCESSED TODAY

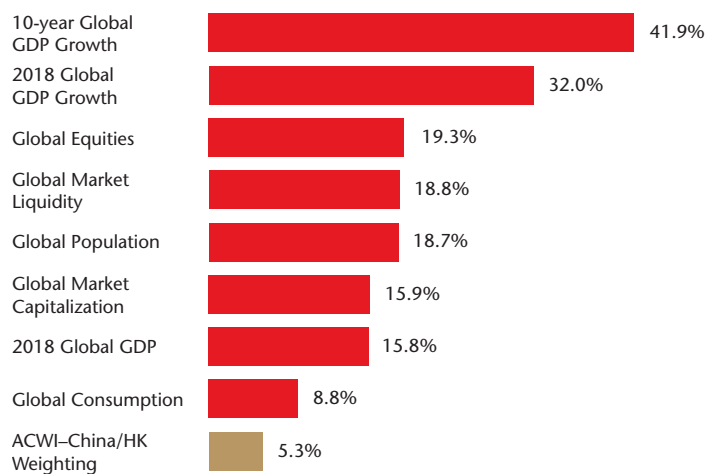
ACWI and China

When constructing a global equity portfolio from a blank sheet, many investors start with the MSCI All Country World Index (ACWI). Allocations then are generally based on home-country bias, growth potential, valuation opportunity and, most importantly, risk tolerance. The current allocation of the ACWI is 55% U.S. equities; 20% European; 7% Japanese; and only 4.2% Chinese (5.3% including Hong Kong).¹ The China allocation, up from just 1.8% a decade ago, is well below any other measure used to build a portfolio representing today's global economy as market cap-weighted indices inherently are backward-looking. The G7, the most economically mature economies, make up 77% of the ACWI today.

While China plus Hong Kong makes up only 1/20th of the global index, the Chinese economy is now the second-largest in the world, making up 15.8% of global GDP and nearly a third of global GDP growth. China has driven 42% of global GDP growth over the past decade, over 1½ times the growth of all G7 countries combined. China also makes up 19% of the global population, 1.8 times the G7 combined, and now drives 9% of global consumption. (See Figure 1.)

Finally, the over 5,300 Chinese plus Hong Kong stocks with a market capitalization greater than US\$50 million make up 19% of global stocks, 16% of global market capitalization and 19% of global market liquidity.² The Chinese market maintains a breadth, depth and liquidity that is second only to the United States globally, and yet it remains an afterthought in global benchmarks.

FIGURE 1. CHINA IS UNDER-OWNED BY NEARLY ANY MEASURE
China as a percentage of the world



Note: MSCI ACWI Index China/Hong Kong weighting as of 6/30/19 from FactSet Research Systems, Inc.; China as a % of Global Consumption figure from World Bank as of 4/24/19; China as a % of 2018 Global GDP, Global Population and Global GDP Growth figures from International Monetary Fund (IMF) as of April 2019; 10-year Global GDP Growth for the time period 2008–2018 from IMF. China as a % of Global Market Cap and Global Market Liquidity (average 52-week \$ traded) from FactSet Research Systems, Inc. as of 6/30/19.

Global Emerging Markets and China

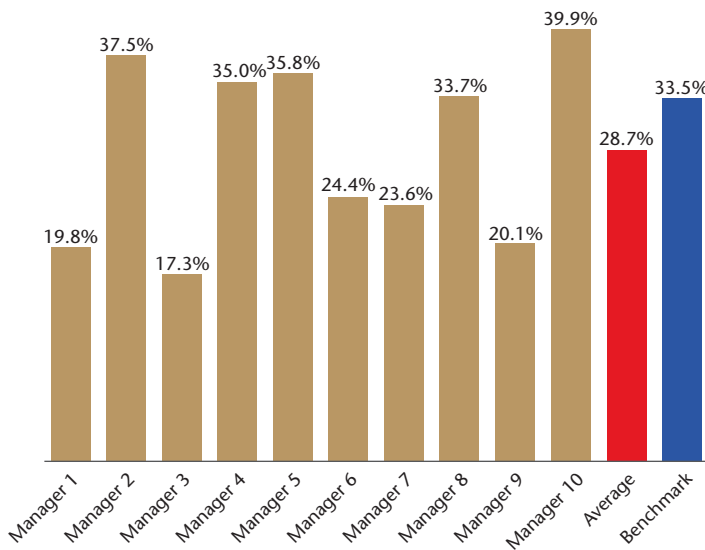
Despite the reasons we believe China should be a much larger allocation, many retail and institutional investors often own even less than the China allocations in the ACWI. Most investors globally still access China through global emerging markets (GEM) strategies and to a lesser extent through Asia regional mandates.

As of June 30, 2019, China made up 33.5% of the MSCI Emerging Markets Index, the primary benchmark for many GEM strategies, including a 1.6% allocation to Chinese onshore-listed A-share stocks.³ The A-share allocation is set to double in 2019, as the inclusion factor increases to 20% from 10%, and will grow to full inclusion over time. But as recently as 2000, China made up only 1.4% of the index.⁴ In our view, this further demonstrates the pitfalls of index construction, with its tendency to overallocate to countries with declining importance in the global economy and underallocate to those on the rise.

1, 2, 3, 4. Source: FactSet Research Systems, Inc.; data as of 6/30/2019

FIGURE 2. ACCESSING CHINA THROUGH GLOBAL EMERGING MARKETS (GEMS)

Percentage of holdings in China and Hong Kong as of June 30, 2019



Benchmark value represented by the MSCI Emerging Markets Index

Note: Global Equity Manager rankings 1 to 10 based on AUM as of 12/31/18 from eVestnet. China and Hong Kong portfolio weights as of 6/30/19 from FactSet Research Systems, Inc.

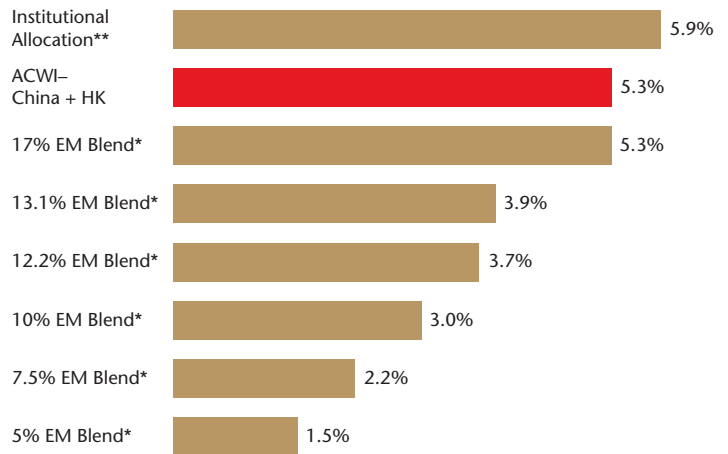
Even in light of its major role in the global equity universe and economy, many GEM managers are persistently underweight to China. Among the 10 largest GEM strategies by institutional assets globally—which make up 20% of the assets of all GEM mandates and 26% of the assets of active mandates—half of the 10 largest strategies are underweight to China plus Hong Kong. The largest GEM managers hold only 85% of the benchmark weight, a simple average weight of just 29% of the portfolio. (See Figure 2.) While the underweight has decreased meaningfully in 2019—as recently as March 31, eight of the largest 10 strategies were underweight by an average of 25%—this underweighting is not a tactical snapshot in time; the sample group has been persistently underweight. Since 2001, when China joined the World Trade Organization and its index weight plus Hong Kong moved to 4.6% of the index from 1.4%, the 10 largest strategies have held a 7% underweight to the region including Hong Kong and a 22% relative underweight to China. Over the past decade, that underweight has been 17% and 27% respectively.⁵

Despite the underallocation, Chinese equities have been a significant driver of long-term alpha for GEM strategies, as nine of the 10 strategies have added value through positive stock selection in China over the past decade. Cumulatively, those strategies have added an average of 285 basis points (2.85%) in relative outperformance annually through stock selection in China and Hong Kong.⁶

Allocation to Global Emerging Markets

While China exposure has been persistently underweight within GEM mandates, the allocation to global emerging markets also remains low relative to the global benchmark. The 25 countries that MSCI considers emerging markets comprise 11.8% of the broad ACWI,⁷ yet many investors are underweight in their exposure to global emerging markets. This underweight is driven by various factors including risk tolerance (broad GEMs tend to be more cyclical

FIGURE 3. INVESTOR HYPOTHETICAL ALLOCATIONS



* Blend portfolios are comprised of 75% average active allocation, represented by the average of the largest 10 Global Equity Manager (GEM) allocations from eVestment as of 12/31/18 and a 25% passive allocation as represented by the MSCI Emerging Markets Index. The 12.2% allocation to EM is meant to represent the median risk model allocation by platform models, often labeled balanced or moderate.

** Institutional figure represents the median Chinese portfolio allocation of 37 institutions from Cambridge Associates “The Case for Dedicated China Exposure,” 2019

and more volatile than developed markets), home-country bias in global portfolios, and legacy issues as emerging markets economies have grown over time while portfolios have been slow to adapt. Looking at a sample of several prominent firms’ asset allocation targets for intermediary usage, we found the range of allocations to GEMs as a percentage of total equity allocations ranged from zero on the most conservative end to 13.1% at the most aggressive growth end. The average percentage of the median risk portfolio (often labeled “balanced” or “moderate”) was 12.2% of global equities.

While active GEM strategies are persistently underweight in China, passive strategies make up 23% of all GEM assets.⁸ On the assumption that the average U.S. intermediary’s target exposure to China is through a 12.2% allocation to GEMs, and is 25% passive and 75% active, in line with the proportion of GEM assets, the Chinese equity exposure on a look-through basis is only 3.5%—less than two-thirds of the ACWI weight and well below other measures of China’s economy.⁹ Given that blend, it would take a 17% allocation to emerging markets to equal the ACWI China exposure. Even the most aggressive model allocation to global emerging markets at 13.1% index weight to China would offer only a 3.9% allocation to Chinese equities as a percentage of the equity portfolio, less than three-fourths ACWI. As few investors’ portfolios match that most-aggressive model, due to the persistent underweight with GEM strategies and allocation to emerging markets, the vast majority of investor portfolios are underweight to China vs. the ACWI, and woefully below any other measure used to build an equity portfolio. (See Figure 3.)

Institutional investors often lead the way. Many now have exposure to China through private equity commitments and are beginning to explore adding a dedicated China allocation. But still, according to a 2018 study by Cambridge Associates of 37 major endowment and foundation investors, the median allocation to Chinese equities on a look-through basis was just 5.9%, including all allocations to private and public equities in

5, 6, 7. Source: FactSet Research Systems, Inc.; data as of 6/30/2019

8. Source: Envestnet; data as of 12/31/2018

9. Source: FactSet Research Systems, Inc.; data as of 6/30/2019

China, with over 40% of respondents holding less than a 5% allocation and nearly half of those respondents expressing a desire to increase their allocation to Chinese equities. Investors outside the U.S. tend to have a lower weighting to U.S. equities as their home-country biases led allocations elsewhere. However, looking across the global investor spectrum, excluding China itself, the vast majority of investors globally access China through GEMs and, to a lesser extent, through Asia ex-Japan strategies. The look-through result is a slightly higher allocation to China vs. U.S. investors, but still well below an allocation in line with China's global position.

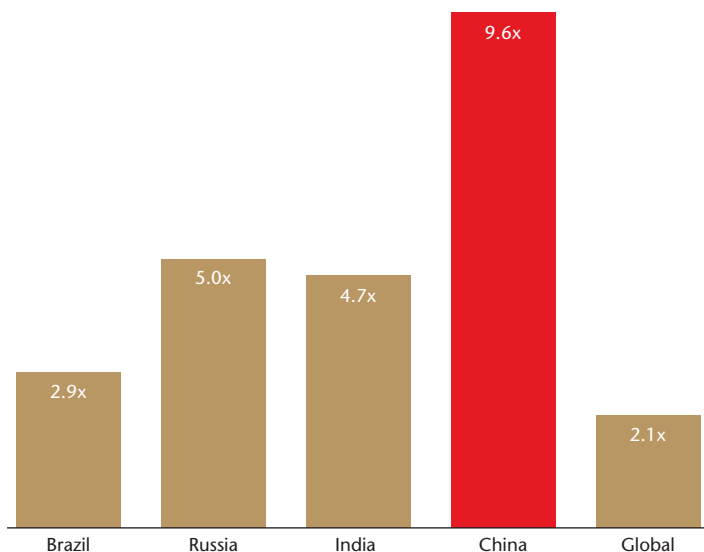
THE CASE FOR CHINESE EQUITIES TODAY

China's Growth Story

There has been talk of the rise of the largest emerging economies for decades, even before the term BRIC was coined in 2001. Brazil, Russia and India each have grown meaningfully from 2001 to 2019, outpacing the global average in terms of GDP per-capita growth from 294% to 497% versus global growth of 208%. That growth pales in comparison to China, which has grown 964%. (See Figure 4.) The future is now for China and we believe its economic growth presents a historic investment opportunity.

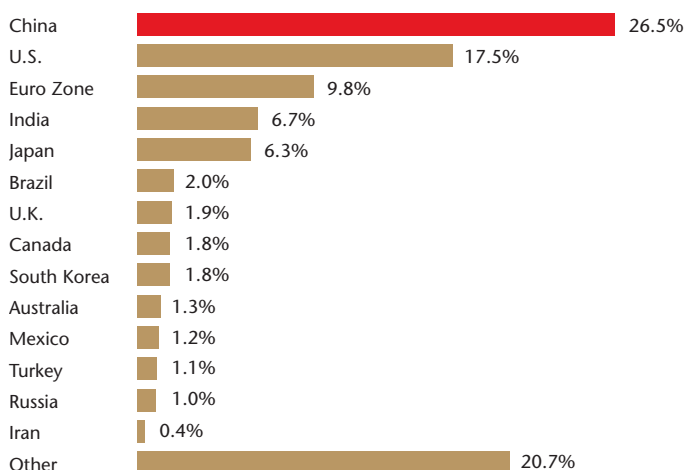
China's growth has been fueled by a rapidly maturing economy as it evolved from being tightly regulated and closed in the 1970s through commercialization and a transition from a centrally planned economy to one driven by changing consumer preferences. China's once-moribund state-owned enterprises have ceded power to market forces, capitalist production and entrepreneurial spirit. Over the past few decades, private businesses have become large contributors to providing consumer goods and services, generating employment and leading to innovation. Today, about 85% of urban employment is driven by privately owned firms.

FIGURE 4. CHINA—A BETTER BUILDING MATERIAL
2001–2019 GDP per-capita growth



Source: International Monetary Fund (IMF), 2019

FIGURE 5. CHINA CONTINUES TO LEAD GLOBAL GROWTH
% of estimated global growth (2019–2023) in real GDP



Note: Based on 2018 GDP estimates from International Monetary Fund (IMF). There is no guarantee any estimates or projections will be realized.

Source: International Monetary Fund (IMF), 2019

Looking forward, China is expected to continue to lead global growth into the 2020s. The International Monetary Fund (IMF) expects China to drive 26.5% of all global GDP growth from 2019 through 2023. China will drive more growth than any other country in the world, 1.5 times the growth generated by the U.S., 7 times Eastern Europe, 4.2 times Japan, and will make up nearly half of the growth from all emerging markets and developing economies combined. (See Figure 5.)

The Development of China's Economy

The next chapter of China's economic growth story is being driven by the evolution from manufacturing to consumption, higher value-adding services, technological development and innovation. Over the past five years, China lost 14 million manufacturing jobs but gained over 70 million service jobs.¹⁰ Today, China makes up 19% of the global population¹¹ and drives 9% of global consumption. Mainland China is the primary revenue source for many multinational companies including Adidas, Samsung, BMW and Intel, and the second-largest source of revenue for Apple, Coca-Cola, Microsoft and Starbucks.¹²

In many ways, China has leapfrogged the developed world in terms of mobile technology. Online shopping arrived in many places before traditional retailers and mobile payments are more common than cash or credit card transactions. Now, for every internet giant in the U.S. or Europe, there is a comparable giant in China. With that technological evolution, growth opportunities are rapidly shifting from coastal areas to inland cities. There are currently 72 cities in China with a population that exceeds 1 million people, each larger than Matthews Asia's home city of San Francisco.¹³ The largest of those cities have an economic impact on the scale of many countries. With a national population of 1.4 billion, and fewer than 100 million living in coastal megacities,¹⁴ a transition of growth to inland cities and towns will lead China's continued growth.

10. Source: Alibaba Group Holding, Ltd.; earnings call 5/14/2019

11. Source: International Monetary Fund; data as of 3/31/2019

12. Source: FactSet Research Systems, Inc.; most recent data as of 6/14/19

13. Source: United States Census Bureau; data as of 7/1/2019

14. Source: World Population Review; data as of 2019

EVOLUTION OF CHINA'S EQUITY MARKET

Equities began trading in China during the 1800s. The stock markets closed during the Cultural Revolution, but China rebuilt its domestic markets by launching the Shanghai and Shenzhen stock markets in 1989. Foreign investors were excluded from access as the central government maintained tight control over monetary policy and the exchange rate, which would typically need to be loosened to allow capital mobility across the border. At that point, firms looking to raise capital outside of China had to look to offshore exchanges in Hong Kong, and later to other overseas markets, including the U.S., Japan, Singapore and Taiwan to limit the capital flows faced by other emerging economies. This restriction was loosened in 1992 with the emergence of B-shares, which trade onshore but are accessible by both foreign and domestic investors. B-shares remain a small portion of China's equity universe.

As China looked to increase the reach of its capital markets, it first increased access by implementing the Qualified Foreign Institutional Investor (QFII) program in 2003, limited to certain financial institutions with over \$500 million through an arduous application process, and the Renminbi Qualified Foreign Institutional Investor (RQFII) program in 2011. Access was further expanded in 2014 with the launch of Stock Connect. This program allows investors to trade shares of a subset of the securities in Shanghai and Shenzhen (beginning in 2016) via the exchange in Hong Kong and vice versa. Stock Connect continues to grow and has eliminated much of the red tape and operational issues of investing onshore by providing T+1 settlement to anyone with a trading account in Hong Kong.

Today, the Shenzhen and Shanghai stock exchanges are the third- and fifth-most liquid in the world independently.¹⁵ As noted earlier, the over 5,300 Chinese plus Hong Kong stocks with a market capitalization of greater than US\$50 million make up 19% of global stocks, 16% of global market capitalization and 19% of global market liquidity.¹⁶ The quality and variety of companies also have improved. Technology companies provide solutions for consumer

entertainment, health care, business efficiency and the distribution of financial products. Innovation is prevalent in the biotechnology and transport industries. Domestic brands are emerging, meanwhile, and demands are increasing for intellectual property (IP) protection.

Everyday businesses that are recognized instantly in the U.S.—insurers, sportswear brands, recruitment firms, liquor companies, fast-food chains, car manufacturers, coffee shops and even pharmaceutical companies—have peers among listed Chinese equities. Other types of businesses in China's equity markets include dating apps, recruitment platforms, peer-to-peer lending platforms and private express parcel-delivery services.

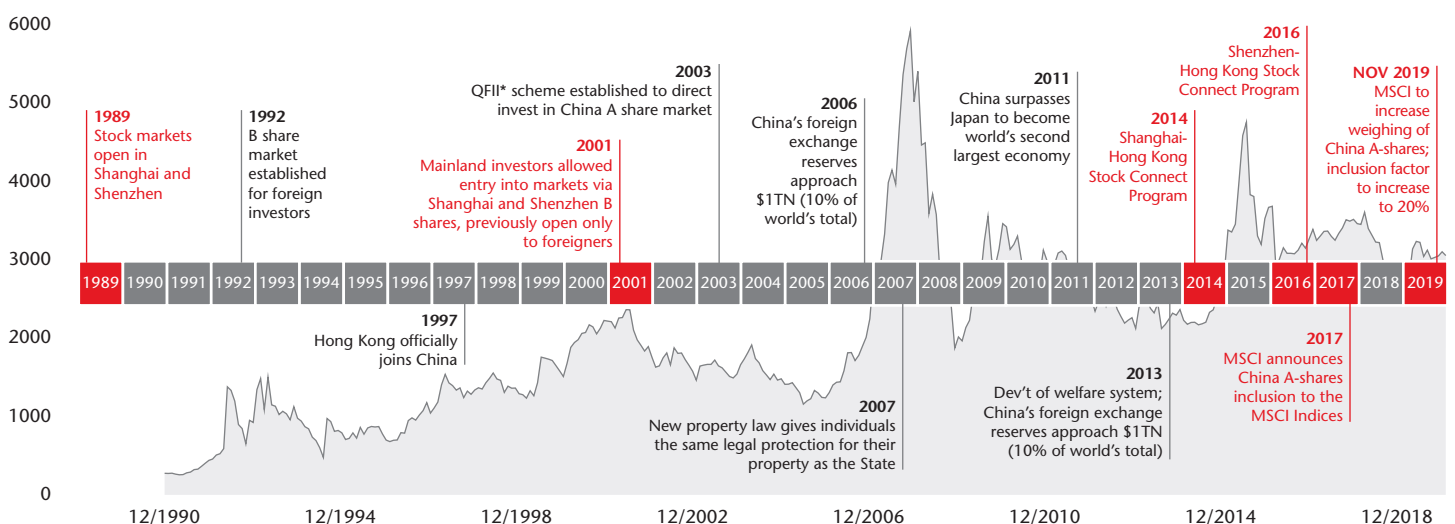
Index Providers Increase Exposure

This evolution and increased access led index providers, including MSCI and FTSE, to increase their exposures to domestically traded Chinese A-shares and, by extension, to China as a whole in recent years. MSCI initiated an initial 5% inclusion of the free-float market capitalization adjusted for foreign ownership limits of 239 China A-shares in 2018. After broad support from market participants, MSCI accelerated plans to increase the inclusion factor to 20% and increase the breath of the securities by including 168 mid-cap stocks and 27 ChiNext shares. (See Figure 7.) This will allow China's exposure in the MSCI Emerging Markets Index to reach 34%, including a 3.9% allocation to A-shares, by November 2019.¹⁷ FTSE also is looking at increasing its exposure to A-shares and expects to be at an even higher level than MSCI. The FTSE Russell Emerging Markets Index will start with a 5% inclusion and gradually rise to 32%.

These increases follow a decision by Barclays early in 2019 that it would begin to include renminbi-denominated bonds in the Bloomberg Barclays Global Aggregate Index. This increase is taking place over 20 months of 5% phase-ins, culminating in November 2020 with a 6.1% index weighting of the US\$54.9 trillion index, smaller only than the exposure to the U.S., European Union and Japan. This further demonstrates the evolution of China's financial markets to a status on a par with developed nations.

FIGURE 6. A HISTORY OF CHINA'S MARKETS

Shanghai Composite Index



Note: Indexes are unmanaged and it is not possible to invest directly in an index.

Source: Wind Info, data as of 6/30/19

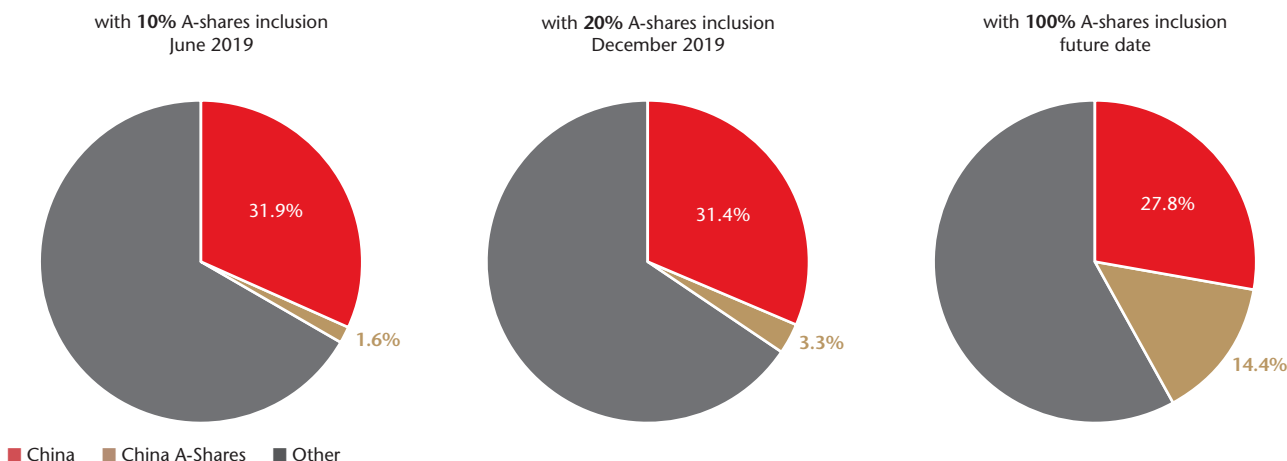
15. Source: Standard Life Aberdeen

16. Source: FactSet Research Systems, Inc.; data as of 6/30/2019

17. Source: MSCI Inc.; data as of 8/19/2019

FIGURE 7. CHINA'S GROWING ROLE IN EMERGING MARKETS

MSCI Emerging Markets Index as of June 30, 2019



Note: There is no guarantee any estimates or projections will be realized. Future figures could differ significantly depending on decisions made by MSCI.
Sources: FactSet Research Systems, Inc.; MSCI; Matthews Asia. Data as of 6/30/2019

WHY NOW IS THE TIME FOR A DEDICATED ALLOCATION TO CHINA

While the increase in index exposure to onshore Chinese equities is expected to bring significant global capital flows to the space, the planned increases are just the tip of the iceberg. This is one of many potential catalysts that could drive a rerating of Chinese equities and provide outside returns for investors who are willing to lead the pack.

Foreign Inflows Related to A-Share Inclusion

As A-shares assume a larger position in global benchmarks, passive and active institutional capital will follow. While active-management flows are difficult to predict and quantify, passive flows alone into A-shares from products that track the MSCI Emerging Markets Index are expected to be over \$13 billion in 2019 as the inclusion factor goes from 5% to 20%. This is in addition to flows from broader MSCI Index-based products including the ACWI and Asia Pacific, as well as similar mandates that track competing benchmarks, including FTSE, as they increase exposure. There is an estimated \$1.9 trillion in assets that track the MSCI EM Index.¹⁸ Each percentage-point increase by the universe would drive an additional \$19 billion in flows, plus flows from other strategies that include China. A move from 20% inclusion to 100% inclusion would cause A-share exposure in the index to increase to 14.4% from 3.3%, or potentially \$210 billion in GEM capital flows alone, in addition to other regional and global index allocation increases.¹⁹ At 100% inclusion, China would make up over 42% of the MSCI EM index. At that level, China is likely to be perceived by investors as a standalone allocation, as the U.S. and Japan are today, and paired with an emerging markets ex-China mandate.

Foreign Inflows Related to Ownership Limits

The move to full inclusion would be meaningful, but it is restricted by China's current foreign ownership limit of 30%. In order to account for this access limitation, MSCI and other index providers use a modified market-capitalization methodology limiting the MSCI market cap to a fraction of the actual free-float market capitalization of the companies. An incremental opening of China's capital markets would have a multiplicative effect, increasing global exposure to China beyond the aforementioned

index weights. If the foreign ownership limit were doubled to 60%, for example, the modified market capitalization of China A-shares would double. This assumes that all shares not included in the free float would be held by domestic investors—which is highly unlikely—so the multiplier would likely be higher.

While an opening of the financial system is a key topic in current U.S.–China trade negotiations, it may only accelerate policy reforms already under consideration in Beijing. We believe an opening would also behoove China as increasing foreign and institutional exposure would boost the credibility of its capital markets and help fund pension liabilities as it manages its demographic shift to an older population. That opening is already underway. Shanghai has vowed to be the first municipal city in China to remove foreign ownership limits on public fund companies as it seeks to cement its position as the country's financial center and a hub for global asset managers.

Domestic Inflows

Beyond the increase in global capital flowing into Chinese equities, domestic equity investment by Chinese investors is low by global standards and likely to increase. Despite China's high savings rate, real estate historically has been the personal investment of choice, making up 60% of retail investor assets, and financial investments have been a small portion of the typical personal balance sheet. That paradigm is shifting as China's younger generations are more financially literate than their parents and take a larger interest in financial investments to achieve their savings goals, including equities and onshore mutual funds. While the majority of Chinese investors still own equities directly, over the past decade the onshore mutual fund industry has grown meaningfully. Since 2008, the mutual fund universe has grown to over US\$2 trillion, up from US\$280 billion, and the pool of equity mutual funds has grown 425%.²⁰ The 2018 policy reforms to eliminate leveraged wealth management products as an investment, along with declining returns from property investments, could lead to more domestic investors looking to equities for compelling returns.

18. Source: eVestment; data as of 12/31/2019

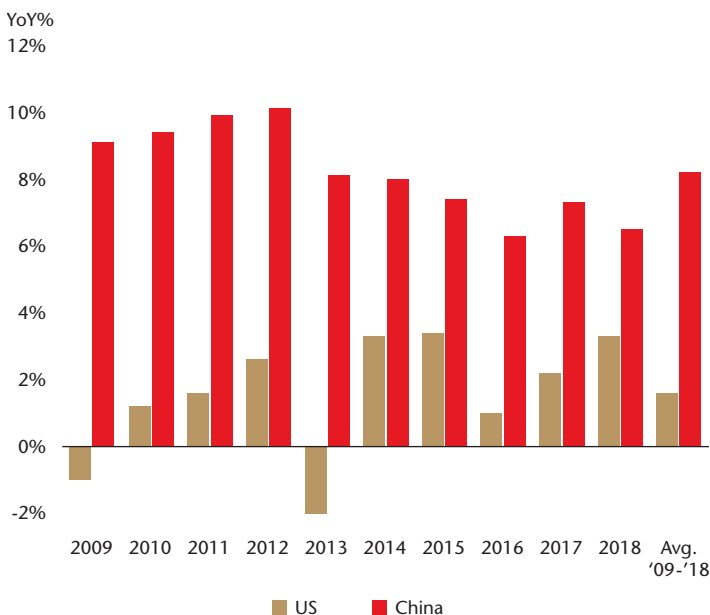
19. Sources: FactSet Research Systems, Inc.; data as of 6/30/2019

20. Source: Strategic Insight; data from 12/2008 to 3/2019; China-domiciled mutual funds; excludes fund-of-funds

Strong Economic and Wage Growth Should Drive Earnings

Another driver of outperformance by Chinese equities compared to global peers is an economic and earnings growth trajectory that is expected to outpace much of the world for years to come. Over the long run, share prices are fundamentally driven by earnings growth. If the equity universe represents the domestic economy, then earnings growth should follow a path similar to that of GDP growth. While over the short run, earnings growth does not always correlate with economic growth, this argument holds most true in parts of the world where a growing portion of revenue is shared with labor rather than the capital supply. Much of the excess organic U.S. earnings growth over the past several years, for example, has been driven by increasing margins—in part due to stable wages as company revenues have increased. By contrast, wages in China have appreciated meaningfully and the labor share of national income has increased as capital share has decreased. (See Figure 8.)

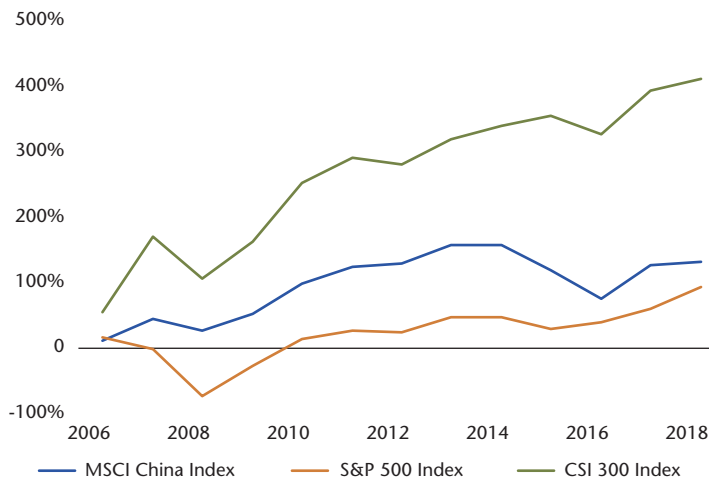
FIGURE 8. CHINA'S INCOME HAS GROWN WITH THE ECONOMY



Source: CEIC, Federal Reserve Bank of St. Louis, NBS

When looking at China over the past 16 years (since China joined the World Trade Organization), as the equity market has evolved to be a more representative subset of the economy, the relationship between earnings and GDP growth has been quite strong. In fact, despite the large excess in GDP growth vs. both the global average and other emerging economies, earnings per share growth of the MSCI China Index has outpaced China's economic growth. That trend is expected to continue for the foreseeable future as consensus earnings growth expectations for 2020 and 2021 are all solidly in the mid to high teens²¹ as GDP growth slows to 6.0% from 6.6% by 2021,²² driven by the effect of a larger base. Additionally, if Chinese companies were to shift their incremental positioning to capital and move to become more in line with developed economies, that would increase margins and earnings accordingly. A mean reversion of allocation toward workers by U.S. and other global companies would have an inverse effect and drive relative outperformance by Chinese equities.

FIGURE 9. CUMULATIVE EARNINGS GROWTH SINCE 2005



Note: Indexes are unmanaged and it is not possible to invest directly in an index.
Source: Bloomberg

The ABCs Of Chinese Stocks

A Shares are available to domestic investors, qualified foreign institutional investors (QFIIs) and through "Stock Connect," which links the Shanghai and Shenzhen stock exchanges to the Hong Kong Stock Exchange and enables foreign investors to access A-shares with fewer restrictions.

B Shares are open to both domestic and foreign investors.

SAR (Hong Kong) Companies are companies that conduct business in Hong Kong and/or mainland China.

China-Affiliated Corporations (CAC), also known as "Red Chips," are mainland China companies with partial state ownership listed in Hong Kong, and incorporated in Hong Kong.

H Shares are mainland China companies listed on the Hong Kong exchange but incorporated in mainland China.

Overseas Listed (OL) Companies are companies that conduct business in mainland China but listed in overseas markets such as Japan, Singapore, Taiwan and the United States.

Over the Counter (OTC) Market, which was established in 2014 in China, allows for shares of non-public companies to be traded.

21. Source: FactSet Research Systems, Inc.; data as of 6/30/2019

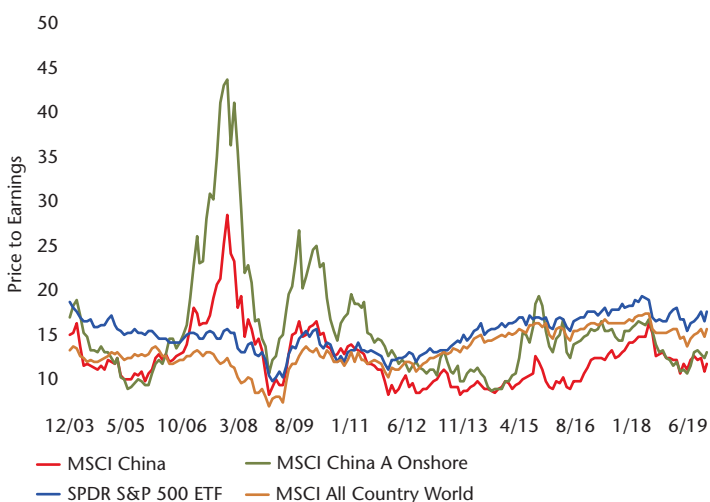
22. Source: International Monetary Fund; data as of 3/31/2019

Valuations Are Attractive vs. Historical and Global Metrics

From a valuation perspective, both the MSCI China and MSCI China A indices are trading below their 20-year trendline and at a discount to equities globally—despite economic and earnings growth that is expected to outpace the world. Currently, the ACWI trades at a 33% forward price/earnings premium to the MSCI China Index, and the MSCI US Index is trading at a 52% premium. The MSCI China A Index trades at a slightly higher multiple and is in line with broad EM, but is still attractive with the ACWI trading at a 20% premium and the MSCI US Index at a 38% premium. Looking at ROE adjusted P/E, the MSCI China A Index ended 2018 at 11.3x, a low since the mid-2000s. (See Figure 10.)

FIGURE 10. VALUATIONS ARE ATTRACTIVE VS. HISTORICAL AND GLOBAL METRICS

December 31, 2003, to June 28, 2019



Indexes are unmanaged and it is not possible to invest directly in an index.

Sources: FactSet Research Systems, Inc., SPDR S&P 500 ETF

Chinese equities also are attractive today on a price-to-book basis, vs. both historical and global metrics. Since 2010, despite the evolution of the indices toward more consumer, technology and services sectors, and away from asset-heavy industries including manufacturing, the price-to-book ratios have declined meaningfully. (See Figure 11.)

While A-shares have historically traded at a valuation premium to the MSCI China Index, averaging 25% over the past 15 years, that premium eroded to parity in 2017 as the Chinese domestic sentiment waned on policy changes and implicit financial tightening through the derisking process of eliminating leveraged wealth management products and reducing the size of the shadow banking and peer-to-peer lending markets.²³ The decline in 2018 of over 35% from A-shares 2018 high and 55% from the market peak in 2015 reduced valuations to a level that historically has preceded large rallies. This opportunity is amplified by sentiment-driven declines, driving multiples lower while earnings remained positive. Today, following a sentiment recovery in early 2019, A-shares trade at an 11% premium, still well below the historical average.

FIGURE 11. CHINA VALUATIONS

MSCI China Index as of June 30, 2019

	MSCI China	MSCI China A Onshore	MSCI Hong Kong	S&P BSE 100	MSCI Japan	S&P 500	MSCI Europe	MSCI AC Asia ex Japan
Forward P/E	11.82	13.05	15.60	19.23	12.44	17.76	14.11	13.58
Price/Book	1.36	1.85	1.25	3.00	1.20	1.57	1.79	1.44

The forward price per earnings ratio ("Forward P/E") is calculated by dividing the market price per share by the expected earnings per share for 2019. Forward P/E was calculated as of June 30, 2019 and is forward looking. There is no guarantee that Forward P/E or any estimates or projections will be realized. Indexes are unmanaged and it is not possible to invest directly in an index.

Institutionalization of Chinese Equities Will Drive a Multiple Rerating

In addition to the flows of international capital creating new demand as A-shares become a larger portion of global indices and investor portfolios, the institutionalization of the market also is a catalyst for multiple rerating. While much of the world's equity universe is dominated by institutions and professional investors, China A-shares remain the inverse. As recently at 2018, approximately 80% of the trading on the A-share market was directed by retail accounts. By comparison, only 15% of U.S. trading volume is driven by retail investors.

The short-term focus and herd mentality of retail investors leads to a higher volatility profile for A-shares, which requires a higher equity risk premium and earnings yield to equity holders and therefore a lower earnings multiple. As global institutional capital flows to the space, and the domestic investment mix becomes more institutional, volatility should subside—creating another positive driver for a valuation rerating to early adopters. A byproduct of increased participation by institutional investors is an emphasis on improving the quality of corporate governance and transparency, which is likely to further reduce the equity risk premium directly as well as drive greater institutional participation.

Over the long run, as both the Chinese economy and equity markets evolve, the multiples should continue to increase to a level more in line with other markets at advanced stages of economic development. While significant steps in the opening of the financial markets are necessary for that to take place, today China's sovereign debt market is widely considered a developed market as evidenced by its A+ credit rating and inclusion in the Bloomberg Barclays Global Aggregate Bond Index.

23. Source: FactSet Research Systems, Inc.; data as of 6/30/2019

Part 2—How To Access China

- While a passive allocation to global emerging markets yields a higher allocation to China than the largest active options, the passive index faces the same flaws as those of the passive options for dedicated China.
- China offers an opportunity for active managers to create alpha over the long term.
- While much of the world's equity universe is dominated by institutions and professional investors, Chinese A-shares remain the inverse.

Once it is established that a global portfolio can benefit from additional Chinese equity exposure, and that now is the time to increase that exposure, the next question is how best to access China's market. A broad set of solutions is available today. These range from active management to passive strategies, including exchange-traded funds, and mandates that range from dedicated onshore A-shares to broad mandates that include all Chinese equities. Other solutions include those focused on Chinese companies listed outside of China, regional strategies and global emerging markets strategies.

Whether taking an active or passive approach, once an investor has decided to make a dedicated China allocation and narrow the gap between a portfolio's weight and the true size of China's economy and equity market, the final question is if that allocation should be to a dedicated A-share strategy or to a go-anywhere China all-share strategy. Both options have pros and cons. The answer is a portfolio-by-portfolio decision based on the type, size, risk profile and current portfolio exposures of the investor.

PASSIVE APPROACH

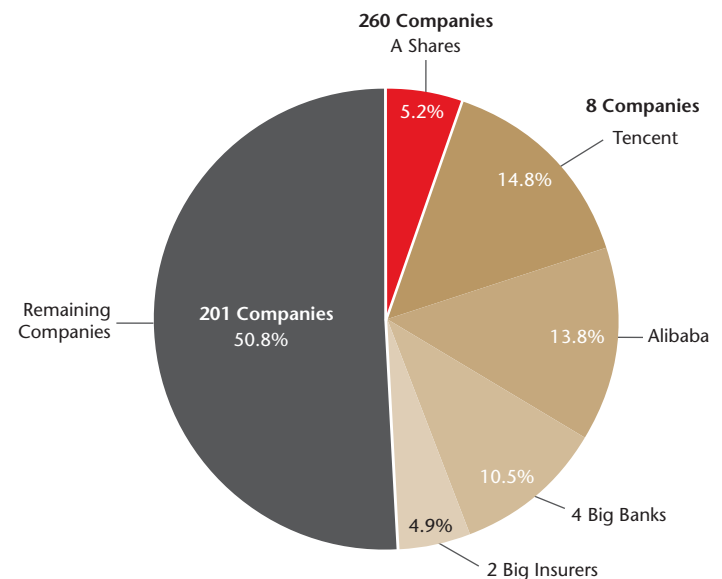
Passive strategies and ETFs deserve consideration in a portfolio. The lower management fees and tax advantages can exceed the alpha opportunity in efficient markets, which are typically the most developed and well-covered, while China remains retail-dominated and inefficient. The majority of passive vehicles are market cap-weighted and track the MSCI China, MSCI China A Index or other comparable indices. Unfortunately, as a representation of a country or region's economy, the MSCI China Index is fundamentally flawed—in part due to its minimal exposure to onshore A-shares. While that allocation will quadruple in 2019 as MSCI increases its inclusion factor, today the allocation to 260 onshore stocks is only 5.2%. The remaining 94.8% of the benchmark is made up of a combination of Hong Kong-listed H-shares, ADRs and stocks available via other offshore exchanges.²⁴

The resulting index is top-heavy, with the two largest companies, Tencent and Alibaba, making up 29% of the index. Additionally, the four largest state-owned banks and the two largest insurers make up another 15%. 461 companies make up the remaining 56% of the index, but only 16% of the index consists of the small- and mid-cap companies that are most closely driven by the demand of the local economy.²⁵ The composition of the index is much more heavily weighted to old economy, state-owned enterprises and commodity-sensitive value stocks than those consumer- and services-focused businesses that are harnessing China's growth.

The Flaws of a Passive Index

While a passive allocation to global emerging markets yields a higher allocation to China than the largest active options, the passive index faces the same flaws as those of the passive options for dedicated China. The China allocation in the MSCI Emerging Markets Index replicates the MSCI China Index and has the same heavy allocation to the top names in the index and financials. (See Figure 12.) Moreover, of the 421 A-shares that are set to be included in the MSCI Emerging Markets Index by the end of 2019, only 26% of the companies excluding financials have an average three-year return on equity that exceeds 8%.²⁶

FIGURE 12. WHY ACTIVE CHINA?
MSCI China Index as of June 30, 2019



Note: Indexes are unmanaged and it is not possible to invest directly in an index.
Source: FactSet Research Systems, Inc.; data as of 6/30/2019

While the MSCI A-Share Index provides greater exposure to new economy sectors including consumer staples, health care and IT, and holds far more (42%) small- and mid-cap stocks that are more focused on the domestic economy, it has many of the same issues as its offshore counterpart.²⁷ Over half of the index is made up of old economy sectors including financials (29%), industrials and materials.

Additionally, over half of both the market cap and number of companies in the MSCI China A-Share Index,²⁸ including eight of the top 10 Index holdings, is allocated to state-owned enterprises. SOEs historically have been inefficient allocators of investor capital and run the additional risk of being called into national service as the central government looks to control pricing in some industries, especially in periods of economic stress.

In addition, for investors concerned with tracking error, due to the sheer size of the Chinese equity universe and operational access hurdles, the majority of passive investment products including ETFs use stratified sampling versus full index replication. This opens a portfolio up to tracking error that is not rewarded by a commensurate expected excess return.

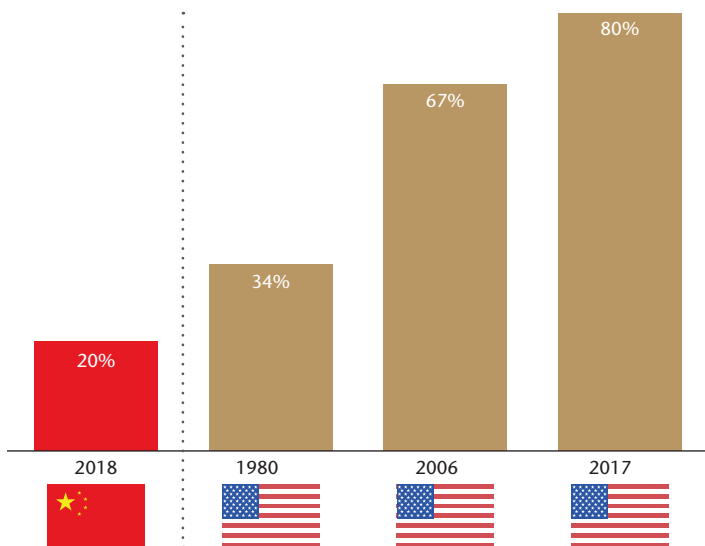
24, 25, 26, 27. Source: FactSet Research Systems, Inc.; data as of 6/30/2019
28. Sources: MSCI Inc.; Wind Information; UBS; data as of 5/31/2019

A CASE FOR ACTIVE MANAGEMENT IN CHINA

With a universe of over 5,300 stocks,²⁹ and flaws in market capitalization-weighted index construction, China offers an opportunity for active managers to create alpha over the long term. This opportunity is most apparent to mandates that are either dedicated to A-shares or those with flexible all-share mandates that allow portfolio managers to allocate both onshore and offshore.

FIGURE 13. INSTITUTIONS ARE UNDER-REPRESENTED

Institutional investor equity-market ownership



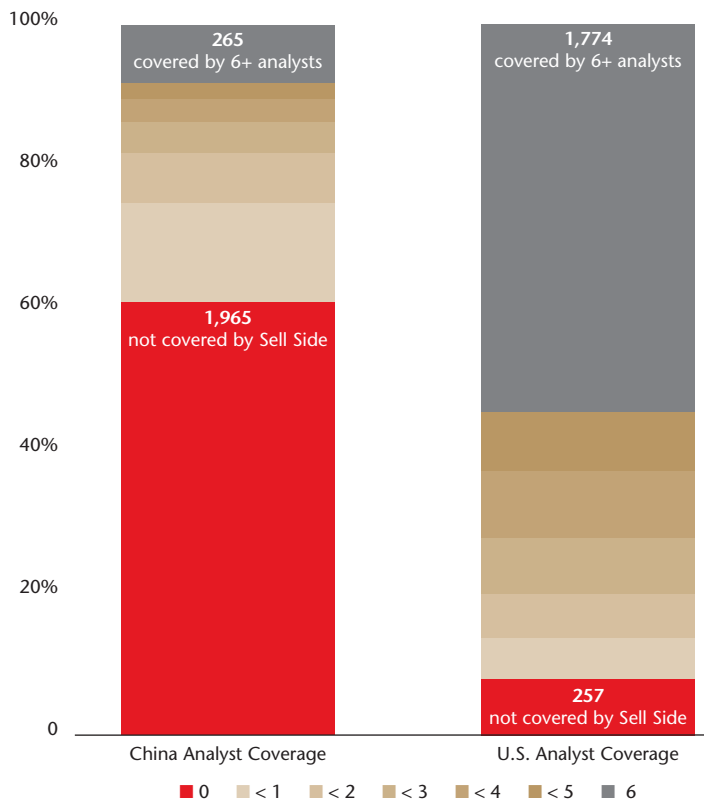
Sources: Bloomberg; The Wharton School of Business

Today, the A-share market is one of the largest in terms of market capitalization and deepest in terms of the number of listed securities and market liquidity—both second only to the U.S.—and yet the vast majority of the current investor base is retail in nature. As noted earlier, while much of the world’s equity universe is dominated by institutions and professional investors, Chinese A-shares remain the exception. (See Figure 13.) As recently at 2018, approximately 80% of the trading in the A-share market was directed by retail accounts, compared to only 15% of U.S. trading volume. Retail investors in China, as well as globally, tend to be more short term-focused than professional investors. Investment acumen and conviction tend to be lower and this retail nature leads to a herd mentality, creating market inefficiencies. This mentality leads to higher volatility in the A-share market compared to offshore and other developing countries, but it also creates valuation opportunities for long term-focused portfolios.

A second-order effect of the size and retail nature of the Chinese equity market is low analyst coverage. Even including megacap names that trade in the U.S., Hong Kong and elsewhere, the broad universe of Chinese equities is widely uncovered by sell-side analysts. While the largest names are covered by as many as 50 analysts, of the 3,200 largest Chinese equities with a market capitalization of greater than US\$100 million for which FactSet tracks analyst coverage, 92% are covered by five or fewer analysts and 61%, over 1,965 companies, are not covered at all by the sell side. (See Figure 14.) Looking at the same universe for U.S. equities, only 46% are covered by fewer than five analysts and only 8%, just 257 stocks, are not covered. This information asymmetry creates another advantage for fundamental active management.

FIGURE 14. INEFFICIENT SANDBOX FOR ACTIVE MANAGERS

Analyst coverage; market cap above US\$100 million



Note: Chart depicts analyst coverage for U.S.-based companies and China-based companies with a market cap above US\$100 million.

Source: FactSet Research Systems, Inc.; data as of 6/30/2019

Capturing the Next Phase of Growth

China is now one of the global leaders in science and technology innovation and is making significant advancements in new economic areas such as smartphone usage, cashless payments and online data utilization. Many of these industries are still nascent and could fuel the economy. As index construction is inherently backward-looking, an active approach gives investors an opportunity to own businesses that will drive the next phase of China’s growth.

Over the three years ending June 30, 2019, which include the run-up of 2017, decline of 2018 and recovery in the first quarter of 2019, there has been a visible increase in the dispersion of returns among the stocks in the MSCI A-Share Index. The highest quintile of stocks by ROE have returned over 15% annually, while the bottom 80% of stocks by ROE offered negative returns. Over the same period, stocks with the lowest quintile by price/earnings ratio were the strongest performers, returning 13.6% annually while the most expensive quintile was down 7.6%, a 21% annual return gap. (See Figure 15.) Over 10 years, the trends are far less apparent and returns by valuation quintile are non-linear with the middle quintile commanding the strongest performance. This demonstrates a growing influence, and reward, to fundamental investors as valuations and profitability have a larger impact on returns. This transition is similar to the development of South Korea and Taiwan as their equity markets matured in the 1990s.²⁹

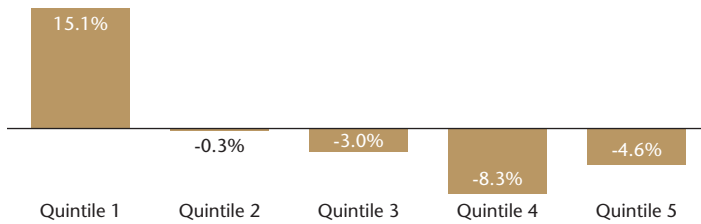
29. Source: FactSet Research Systems, Inc.; data as of 6/30/2019

The Importance of the Right Manager

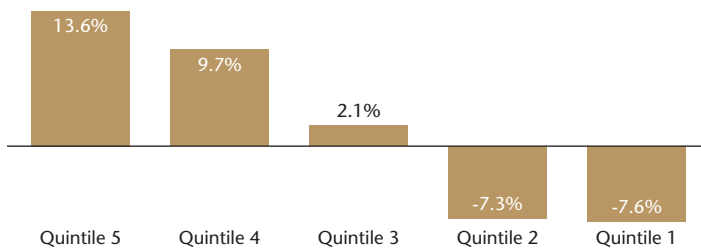
This dispersion of returns extends to active managers within the space, demonstrating that, while there is a case to increase allocations to China, selecting a manager who can extract alpha from the aforementioned inefficiencies is paramount. Successfully uncovering value creators and companies with strong corporate governance in a vast universe requires a deep team that has language skills and spends substantial time on the ground in China.

FIGURE 15. WIDE RANGE OF OUTCOMES FOR STOCKS AND ACTIVE MANAGERS

3-Year MSCI China A Onshore Return on Equity



3-Year MSCI China A Onshore Price-to-Earnings

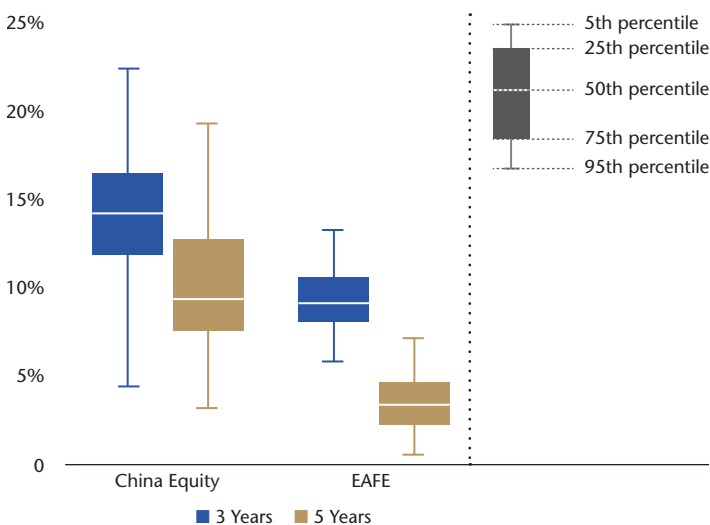


Note: Past performance is no guarantee of future results. Indexes are unmanaged and it is not possible to invest directly in an index.

Sources: ROE and P/E data from FactSet Research Systems, Inc.; data as of 6/30/2019

FIGURE 16. WIDE RANGE OF OUTCOMES FOR STOCKS AND ACTIVE MANAGERS

Active manager returns



Note: Past performance is no guarantee of future results. Indexes are unmanaged and it is not possible to invest directly in an index.

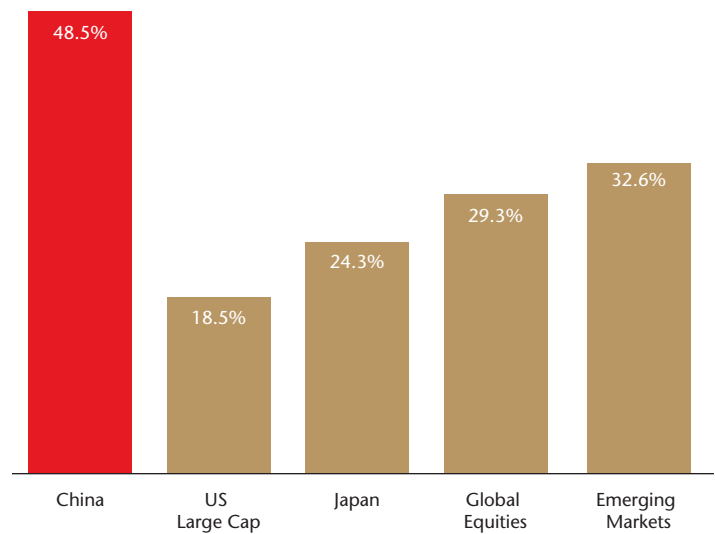
Source: Active manager returns data from eVestment, data as of 6/30/2019

Over those same three years ending June 30, 2019, when looking at all China mandates reported to eVestment, the 25th percentile strategy returned 16.3% annually while the 75th percentile strategy returned 11.8%, a difference of 449 basis points (4.49%) annually, and the difference between the 5th and 95th percentile was over 18% annually. Over five years, the gap between a top and bottom quartile manager was even wider at 521 basis points (5.21%) annually. (See Figure 16.) To put this dispersion in manager performance in context, within EAFE mandates, the three-year difference between top and bottom quartile is 354 basis points (3.54%), 217 basis points (2.17%) over five years.

When looking at all of the China strategies in the U.S. mutual fund space, plus commingled structures listed in Europe, Asia and Africa, 49% of China strategies have outperformed their benchmark net of fees over the past five years. (See Figure 17.) While this seems low given the alpha opportunity, it compares favorably to the five-year success rates of 19% for U.S. large cap and 29% for global equity mandates over the same period. Emerging markets strategies are slightly higher than developed markets in part from the alpha added from their China investments.

Figure 17. ACTIVE MANAGER SUCCESS

% of managers that have outperformed their benchmark over 5 years, net of fees



Past performance is no guarantee of future results.

Source: Morningstar; data as of 6/30/2019; Universe includes Morningstar US & Europe/Africa/Asia open-ended categories for the respective regions, using the oldest share class only. The list encompasses all the strategies in the Morningstar database.

Part 3—Which Strategy Or Approach?

- ✿ Despite a lack of conviction, the majority of global emerging markets strategies have added value through their stock selection in China.
- ✿ A dedicated A-share allocation provides greater exposure to new economy sectors including consumer staples, health care and information technology that are positioned to be the key drivers of the next phase of China's economic growth.
- ✿ A “go-anywhere” China all-shares strategy has the ability to invest in all Chinese equities within its mandate regardless of where shares trade: onshore in Shanghai or Shenzhen, Hong Kong, U.S. ADRs, or any other global exchange.

GEM APPROACH

An active approach has proven to add value for dedicated China mandates (offshore, A-share and all-China). Many investors access Chinese equities through an allocation to a global emerging markets (GEM) strategy, however, and most active GEM mandates are underweight China.

Despite the lack of conviction, the majority of GEM strategies have added value through stock selection in China. Over the past three years, eight of 10 largest GEM strategies by assets under management have added value and on average the 10 strategies added 5.2% to relative strategy returns through stock selection in China. Over five years, results are mixed as only five of 10 outperformed and the average that stock selection added was only slightly positive. Over 10 years, stock selection in China added 2.8% annually.³⁰ Unfortunately, the positive impacts of this stock selection were muted by the persistent underweight to China. This underweight is a bit counterintuitive given the success over time frames, the inefficiencies and the wide dispersion of returns in China.

The demand for internal resources is high in China, however, due to the lack of analyst coverage. This difficulty is evidenced by a lower average active share, averaging 66% in the China/Hong Kong portion of the portfolio vs. 74% for the broad portfolio held by the top global GEMs despite a large universe from which to choose: Chinese companies make up 41% of the companies in the index.³¹

CHINA A-SHARE STRATEGY

A dedicated A-share allocation provides greater exposure to new economy sectors including consumer staples, health care and IT that are positioned to be key drivers of the next phase of China's economic growth and typically have little overlap in terms of exposure with an existing equity portfolio. The MSCI Emerging Markets Index allocation to A-shares today is 1.6% (though it will double in 2019) and the most-used GEM active managers average only a 3.2% allocation with four of the largest 10 GEM managers by AUM holding zero A-shares.³²

While the volatility of a dedicated A-share allocation has historically been higher than a global equity portfolio, the domestic and retail nature leads to an idiosyncratic return pattern that maintains a low correlation to global equities and can enhance an existing portfolio. Over the past decade, the correlations of the MSCI China A Index to the S&P 500 Index and MSCI EAFE have been only 0.42 and 0.41 respectively. While correlations have

increased as China's markets have matured and global capital has begun to flow into the market, over the past three years, in an era of global convergence, they are still quite compelling at 0.57 and 0.56 vs. the respective developed benchmarks. (See Figure 18.)

While more additive from a portfolio construction standpoint, access to a top-tier dedicated A-shares strategy may be difficult for some investors. Given the dispersion of returns for both equities and active managers, many of the top active products in the space are structured as LLC or LP products with large minimum investments or investible asset requirements and inaccessible by many non-institutional investors. In addition to accessibility concerns, these vehicles often offer limited liquidity terms, restricting access to make or redeem investments to a monthly or quarterly basis. Finally, a dedicated A-share mandate limits the universe to onshore listings, when many dual-listed stocks currently trade at a discount on the Hong Kong exchange. While many passive vehicles including ETFs remove the capital and liquidity hurdles, the flaws in benchmark construction lead to an adverse selection in terms of the exposures outlined previously.

FIGURE 18. A-SHARES HAVE LOW CORRELATIONS WITH GLOBAL MARKETS

3-year correlations as of June 30, 2019

	MSCI ACWI	S&P 500	MSCI EAFE	MSCI EM	MSCI China	MSCI China A Onshore	MSCI China All Shares	MSCI China Small
MSCI ACWI	1.0							
S&P 500	0.96	1.0						
MSCI EAFE	0.94	0.81	1.0					
MSCI EM	0.84	0.69	0.86	1.0				
MSCI China	0.82	0.73	0.77	0.90	1.0			
MSCI China A Onshore	0.62	0.57	0.56	0.66	0.77	1.0		
MSCI China All Shares	0.80	0.72	0.74	0.87	0.97	0.90	1.0	
MSCI China Small	0.65	0.57	0.62	0.72	0.86	0.80	0.88	1.0

*Monthly performance correlation from 6/30/2016 to 6/30/2019 in USD. Indexes are unmanaged and it is not possible to invest directly in an index.

Source: Zephyr StyleAdvisor; data as of 6/30/2019

CHINA ALL-SHARES STRATEGY

Another option for investors to increase their allocation to China and A-shares is through a “go anywhere” China all-shares strategy. These strategies can invest in all Chinese equities within their mandate regardless of where the shares trade: onshore in Shanghai or Shenzhen, Hong Kong, American depositary receipts or any other global exchange. They tend to be more easily accessible from a product-structure standpoint and typically offer daily or, in the case of ETFs, intraday liquidity. They also allow a portfolio manager to choose the exchange for cross-listed securities, potentially giving them the opportunity to buy a stock at a discount onshore or offshore.

30, 31, 32. Source: FactSet Research Systems, Inc.; data as of 6/30/2019

On the downside, these strategies often are anchored by a large allocation to offshore Chinese equities, which tend to have a higher overlap with existing exposure through GEM or other global allocations. The correlations of all share mandates to a global equity portfolio tend to be higher because of that overlap and the greater impact of global capital flows. Volatility tends to be lower for the same reasons.

The overlap today is primarily limited to the offshore portion of a China all-shares portfolio. As the Chinese financial system continues to open and institutionalize, and as A-shares and China become a larger portion of emerging and global indices, there will be a convergence of portfolios that will reduce the correlation benefits of China A-shares, but that convergence creates an opportunity today.

While there are pros and cons to making a dedicated allocation to A-shares vs. a go-anywhere all-shares mandate, both can capitalize on inefficiencies in Chinese equities and the resulting dispersion of outcomes. A dedicated allocation to China has the ability to increase portfolio alpha while increasing growth exposure and providing correlation benefits.

Part 4—Overcoming Objections

- ✿ Will the U.S.–China trade conflict slow growth in China?
- ✿ Won't China's debt burden hinder growth?
- ✿ Aren't investors getting exposure to China through multinationals?

China's growth is slowing, from 9.6% in 2008, to 6.6% in 2018, to an estimated 5.6% in 2023, according to the IMF. Much of that decline is driven by the base effect, however, as the economy continues to grow and Chinese GDP has grown from \$4.6 trillion to \$13.4 trillion annually over the past decade. The 9.6% of GDP growth in 2008 led to nominal year-over-year GDP growth of \$1.03 trillion while the "lower growth" in 2018 led to GDP growth of over \$1.34 trillion. The IMF expects China to make up 17.3% of global GDP over the next five years, over \$84 trillion, second only to the U.S., and more than South America, Eastern Europe, South Asia and the Middle East combined. China is expected to surpass the U.S. and become the world's largest economy by 2030.

WILL THE U.S.–CHINA TRADE CONFLICT SLOW GROWTH?

The trade conflict between China and the U.S. has driven the news and investor sentiment in 2018 and 2019, and the short-term direction of U.S.–China relations has been unpredictable. Many in the Trump administration clearly advocate disengagement from China and escalating the trade conflict into an economic war. Others, however, are working to negotiate a trade deal.

If the dispute escalates further, there are a few key points to keep in mind. Most importantly, the Chinese economy is no longer export-driven. This means the impact of a trade war with the U.S. would be modest. Net exports (the value of a country's exports minus the value of its imports) accounted for only 2% of China's GDP in 2017, down from a peak of 9% in 2007. In contrast, domestic consumption now accounts for the majority of China's economic growth and more than half of its GDP.

China's exports to the U.S., moreover, accounted for only 19% of total Chinese exports in 2017, prior to the current trade conflict. Much of the impact of U.S. tariffs will be borne by U.S. consumers and not Chinese companies. While the additional costs will likely lead to declining demand, Chinese exporters are not yet suffering. If exports to the U.S. were to fall, Beijing has the fiscal resources and political will to support domestic firms and mitigate the impact of weak exports—just as it did a decade ago during the Global Financial Crisis. As a result, we believe the trade conflict is unlikely to cause significant long-term damage to China's economy.

Additionally, given the depth of the investible universe in China, the trade conflict could provide an opportunity for active managers within China as MSCI China valuation multiples have contracted 27% since the first round of tariffs on washing machines and solar panels were implemented in January of 2018.³³ The declines amid rising rhetoric have been broad-based, creating opportunities to identify businesses that are unaffected by trade as well as those that have sold off far more than their export exposure warrants.

China A-Shares Approach vs. China All-Shares Approach

Dedicated China A-Shares

Pros

- ✿ Lower correlations to global equities
- ✿ Higher return profile historically
- ✿ Greater exposure to new economy sectors

Cons

- ✿ Many top-tier strategies are private vehicles with limited liquidity
- ✿ Unable to buy cross-listed A/H shares at a discount
- ✿ Diminishing benefits as A-shares are included in global indices

Source: Matthews Asia

China All-Shares

Pros

- ✿ Broadest mandate – go-anywhere
- ✿ Greater accessibility, product liquidity
- ✿ Lower historic volatility
- ✿ Represents future MSCI China as indices converge

Cons

- ✿ Greater overlap with existing GEM holdings
- ✿ Market behavior differs across different exchanges
- ✿ Higher correlations to global equities
- ✿ Lower return profile historically

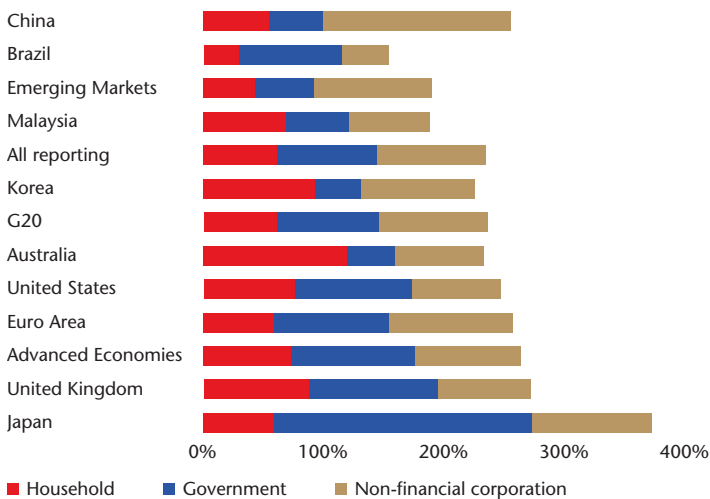
33. Source: FactSet Research Systems, Inc.; data from 1/19/2018 to 6/30/2019

WON'T CHINA'S DEBT BURDEN STALL GROWTH?

China's debt problem is serious, but we believe the risk of a hard landing or banking crisis is low. The reason is that the potential bad debts are corporate, not household, and were incurred at the direction of the state—by state-controlled banks to state-owned enterprises. This provides the state with the ability to manage the timing and pace of recognition of nonperforming loans. Over the past few years, China's de-leveraging efforts have helped to reduce corporate leverage, cut excess industrial capacity, cleaning up banks' balance sheets by recognizing bad debt, and containing the shadow-banking system. It is also important to note that the majority of potential bad debts are held by state-owned firms, while the leverage of the privately owned companies that employ the majority of the workforce and account for the majority of economic growth isn't high. Additional positive factors are that China's banking system is very liquid, and that the process of dealing with bad debts has begun.

FIGURE 19. CHINA'S DEBT PROBLEM IN CONTEXT

Debt-to-GDP ratios, as of March 2019



Source: Bank of International Settlements

Understanding the composition of China's debt is important to evaluating the seriousness of the problem. A key factor is that the Chinese household debt-to-GDP ratio is relatively low, about 54%, compared to 75% in the U.S., 87% in the U.K. and 58% in the eurozone as of March 2019. (See Figure 19.) The largest share of Chinese household debt is home mortgages, moreover, and these are far safer than the mortgages that created significant problems in the past decade for households in the U.S. and U.K. About 90% of new homes in China, for example, are bought by owner-occupiers (not speculators) who are required to pay a minimum of 20% cash to receive a mortgage, and most put down 30% cash or more—far above the U.S. median cash down payment of 2% of the purchase price in 2006.

China's de-leveraging efforts in the past two to three years have certainly helped as corporate leverage was reduced, industrial excess capacities were cut, banks' balance sheets were cleaned up somewhat as more bad debt was recognized and disposed, and shadow credit was contained.

AREN'T INVESTORS GETTING EXPOSURE THROUGH MULTINATIONALS?

Some investors might believe they are accessing China's growth through exposure via shares of global multinational companies. These often are megacap stocks and hold a disproportionate weight in equity portfolios. GDP per capita in China has risen to over \$10,000 in 2019, up from just \$872 in 1999, and China is a significant customer for many multinationals. The exposure of revenue from China for the ACWI, however, is still less than 10% and only 5.6% when excluding Chinese stocks within the index.³⁴ Additionally, this revenue exposure consists of all industries and includes natural-resource companies that export to China as well as makers of consumer goods that are driving the growth of the Chinese economy. That mix will evolve with the standards of living in China, but for the foreseeable future the majority of the growth in Chinese consumption will be driven by local consumer goods and services businesses, not by global corporations. Today, many of the market leaders in the consumer discretionary and communication services sectors have no multinational competitors.

Part 5—Conclusion

- ✿ An investment in China today may benefit from an increasing role in global benchmarks.
- ✿ Active management has historically shown the ability to add alpha by taking advantage the inefficient nature of Chinese equities.
- ✿ A 5% to 10% allocation to a dedicated China portfolio may help narrow the gap between an investor's existing allocation and China's position in the world, today and in the future.

While China is now second only to the U.S. in terms of its role in global GDP, and even in light of the breadth, depth, and liquidity of its equity markets, it remains an afterthought in most global equity portfolios. Many investors still access Chinese equities only through a global emerging markets strategy, and many of the largest GEM strategies systemically underweight China. The compound effect of this is an end allocation to China that is well below its weight in the MSCI ACWI and in our opinion woefully below any other metric used to construct an equity portfolio. (See Figure 20.)

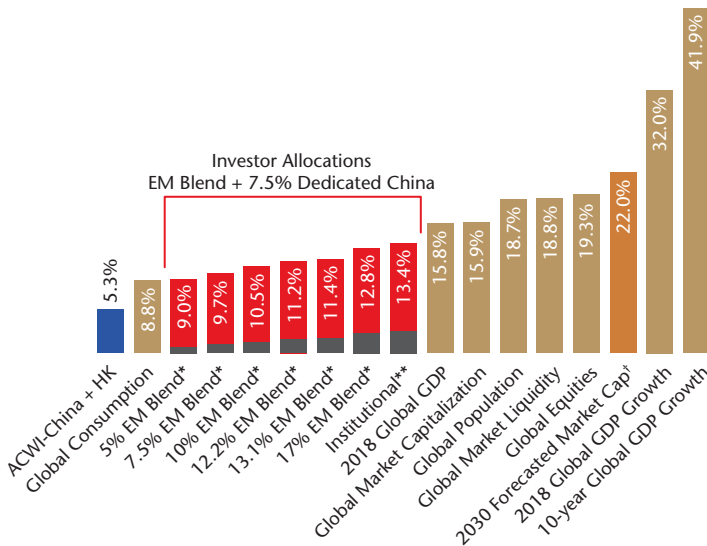
China is expected to remain among the fastest-growing countries in the world for the next decade, driven by the broadening of consumption from the large coastal cities to the rest of the country. Beyond those long-term drivers, the earnings growth and valuations of Chinese equities are attractive compared to their global peers. We believe an investment in China today also will benefit from an increasing role in global benchmarks. Additionally, as its scale grows, it will likely become a stand-alone asset class. The institutional flows that will likely follow should drive an upward multiple re-rating for investors willing to lead the way as the Chinese market becomes less volatile and begins to look more like its developed-market peers.

Given the issues inherent in using backward looking indices, active management has historically shown the ability to add alpha by taking advantage the inefficient nature of Chinese equities. While the pros and cons of a dedicated A-share strategy versus a more flexible China all-shares strategy will need to

34. Source: FactSet Research Systems, Inc.; data as of 6/30/2019

FIGURE 20. CHINA IS UNDER-OWNED BY NEARLY ANY MEASURE

A 7.5% dedicated China allocation narrows the gap



*Blend portfolios are comprised of 75% average active allocation, represented by the average of the largest 10 Global Equity Manager (GEM) allocations from eVestment as of 12/31/18 and a 25% passive allocation as represented by the MSCI Emerging Markets Index. The 12.2% allocation to EM is meant to represent the median risk model allocation by platform models, often labeled balanced or moderate. Allocation's Exposure to China is based on the underlying blend.

**Institutional figure represents the median Chinese portfolio allocation of 37 institutions from Cambridge Associates "The Case for Dedicated China Exposure", 2019

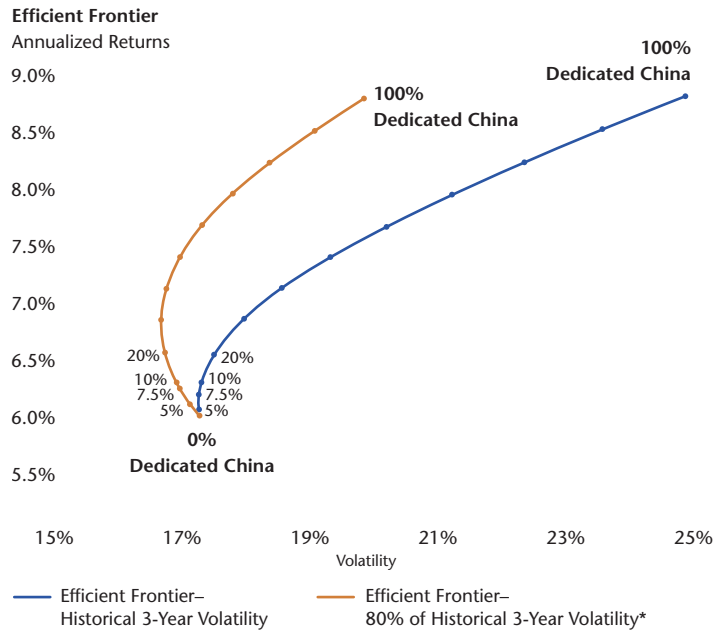
†2030 Forecasted Global Equity Market Capitalization for China/Hong Kong sourced from Bloomberg, MSCI, Thomson Reuters, World Federation of Exchanges, Credit Suisse Estimates. There is no guarantee any estimates or projections will be realized. Note: MSCI ACWI Index China/Hong Kong weighting as of 6/30/19 from FactSet Research Systems; China as a % of Global Consumption figure from World Bank as of 4/24/19; China as a % of 2018 Global GDP, Global Population and Global GDP Growth figures from International Monetary Fund (IMF) as of April 2019; 10-year Global GDP Growth for the time period 2008 – 2018 from IMF. China as a % of Global Market Cap, Global Equities and Global Market Liquidity (average 52-week \$ traded) from FactSet Research Systems, Inc. as of 6/30/19.

be weighed portfolio by portfolio, a 5% to 10% allocation to a dedicated China portfolio will help narrow the gap between an investor's existing allocation and China's position in the world, today and in the future.

Using J.P. Morgan Asset Management's forward-looking asset class assumptions with three-year historical volatility and correlations, a 7.5% allocation of an existing ACWI based portfolio to dedicated China will increase the expected annual returns from 6.00% to 6.21% with no change in the portfolio's volatility profile, given the correlation benefits. If the institutionalization of China's equity market leads to a 20% reduction in volatility from 24.8% to 19.8%, which still exceeds broad EM, that 7.5% allocation would still increase expected returns by 21 basis points (0.21%) annually, while also reducing portfolio volatility by 26 basis points (0.26%) annually.³⁵ (See Figure 21.)

FIGURE 21. ADDING AN ALLOCATION TO DEDICATED CHINA

% allocation to dedicated China from MSCI ACWI



Note: Dedicated China represented by MSCI China All Shares Index against the MSCI All Country World Index, where a 0% allocation to MSCI China All Shares equals to a 100% allocation to MSCI ACWI. Similarly, a 100% allocation to MSCI China All Shares equals a 0% allocation to MSCI ACWI. *80% of Historical 3-year Volatility is to illustrate a reduction in China's future volatility as China's markets become more institutionalized based on Matthews Asia calculations. There are no guarantee any estimates or assumptions will be realized. Volatility is the standard deviation of returns. Past performance is no guarantee of future returns. Indexes are unmanaged and it is not possible to invest directly in an index.

Sources: Annualized return assumptions from JP Morgan Asset Management "2019 Long-Term Capital Market Assumptions" as of September 30, 2018 based on projected EPS growth, multiple re-rating, and dividend yield. Volatility data from FactSet Research Systems, Inc. as of 6/30/19; Correlations data from Zephyr as of 6/30/19; Efficient Frontier created using Morningstar asset allocation optimizer. Data based on 3-year historical returns from June 30, 2016 to June 30, 2019.

All of this makes a compelling case for making a dedicated allocation to China, and doing so through an actively managed strategy with the flexibility to invest in A-shares as warranted. It further makes a case for not waiting. As Ray Dalio, founder and co-CIO of Bridgewater Associates, said in a Goldman Sachs report published on July 11, 2019: "I think if investors look back on this moment one day in the distant future, and see they didn't have any exposure to China at the beginning of the 21st century – when China is already the world's second largest economy, and its markets are growing fast—they'll regret it."

35. Sources: J.P. Morgan Asset Management; Zephyr; FactSet Research Systems, Inc.; Morningstar, Inc.; data as of 6/30/2019

About the author

Jeremy Murden is a Portfolio Strategist at Matthews Asia. In his role with the investment team, Jeremy serves as a proxy to portfolio managers and provides macro thought leadership and individual portfolio insights to clients. Prior to joining Matthews Asia in 2018, Jeremy spent 10 years as a Senior Investment Manager Analyst and Investment Committee Member at William Blair, leading external equity manager coverage. He started his career in distribution as a Product Specialist at Claymore Securities, now known as Guggenheim Funds. Jeremy earned his MBA from the University of Chicago Booth School of Business and a Bachelor of Science in Commerce from DePaul University. He also holds the Chartered Alternative Investment Analyst designation.

Index Definitions

The MSCI All Country World Index (ACWI) captures large and mid-cap representation across 23 Developed Markets (DM) and 26 Emerging Markets (EM) countries. With 2,844 constituents, the index covers approximately 85% of the global investable equity opportunity set.

The MSCI Emerging Markets Index captures large and mid-cap representation across 23 Emerging Markets (EM) countries. With 833 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index is a free-float market capitalization-weighted index across developed market countries around the world, excluding the U.S. and Canada.

The MSCI All Country Asia ex Japan Index is a free float-adjusted market capitalization-weighted index of the stock markets of China, Hong Kong, India, Indonesia, Malaysia, Pakistan, Philippines, Singapore, South Korea, Taiwan and Thailand.

The MSCI China Index is a free float-adjusted market capitalization-weighted index of Chinese equities that includes H shares listed on the Hong Kong exchange, B shares listed on the Shanghai and Shenzhen exchanges, Hong Kong-listed securities known as Red chips (issued by entities owned by national or local governments in China) and P Chips (issued by companies controlled by individuals in China and deriving substantial revenues in China), and foreign listings (e.g. ADRs).

The MSCI China All Shares Index captures large and mid-cap representation across China A shares, B shares, H shares, Red chips (issued by entities owned by national or local governments in China), P chips (issued by companies controlled by individuals in China and deriving substantial revenues in China), and foreign listings (e.g. ADRs). The index aims to reflect the opportunity set of China share classes listed in Hong Kong, Shanghai, Shenzhen and outside of China.

The MSCI China A Index captures large and mid-cap representation across China securities listed on the Shanghai and Shenzhen exchanges. The index covers only those securities that are accessible through "Stock Connect."

The MSCI China Small Cap Index is a free float-adjusted market capitalization-weighted small cap index of the Chinese equity securities markets, including H shares listed on the Hong Kong exchange, B shares listed on the Shanghai and Shenzhen exchanges, Hong Kong-listed securities known as Red Chips (issued by entities owned by national or local governments in China) and P Chips (issued by companies controlled by individuals in China and deriving substantial revenues in China), and foreign listings (e.g., ADRs).

The MSCI Japan Index is a free float adjusted market capitalization weighted index of Japanese equities listed in Japan.

The MSCI Hong Kong Index is designed to measure the performance of the large and mid cap segments of the Hong Kong market. The index covers approximately 85% of the free float-adjusted market capitalization of the Hong Kong equity universe.

The MSCI Europe Index is a free float-adjusted market capitalization-weighted index of the stock markets across 15 developed markets in Europe.

The MSCI USA Index is a free float adjusted market capitalization index that is designed to measure large and mid-cap US equity market performance.

The CSI 300 Index is a capitalization-weighted stock market index designed to replicate the performance of 300 stocks traded in the Shanghai and Shenzhen stock exchanges.

The S&P Bombay Stock Exchange 100 (S&P BSE 100) Index is a free float adjusted market capitalization weighted index of 100 stocks listed on the Bombay Stock Exchange.

The S&P 500 Index includes 500 leading companies in leading industries of the U.S. economy, capturing 75% coverage of U.S. equities.

The FTSE Emerging Index provides investors with a comprehensive means of measuring the performance of the most liquid companies in the emerging markets.

It is not possible to invest in an Index.

As of November 30, 2019, Matthews Asia portfolios held positions in Tencent Holdings, Ltd.; Alibaba Group Holding, Ltd.; and Samsung Electronics Co., Ltd. As of November 30, 2019, Matthews Asia portfolios did not hold positions in Adidas AG; Bayerische Motoren Werke AG; Intel Corp.; Apple Inc.; Coca-Cola Co.; Microsoft Corp. or Starbucks Corp.

Investments involve risk. Past performance is no guarantee of future results. Investing in international and emerging markets may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation.

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