

FIRE & POLICE PENSION ASSOCIATION of COLORADO



# 2019 FPPA Asia Primer

Liquid Strategies Team

**FPPA**

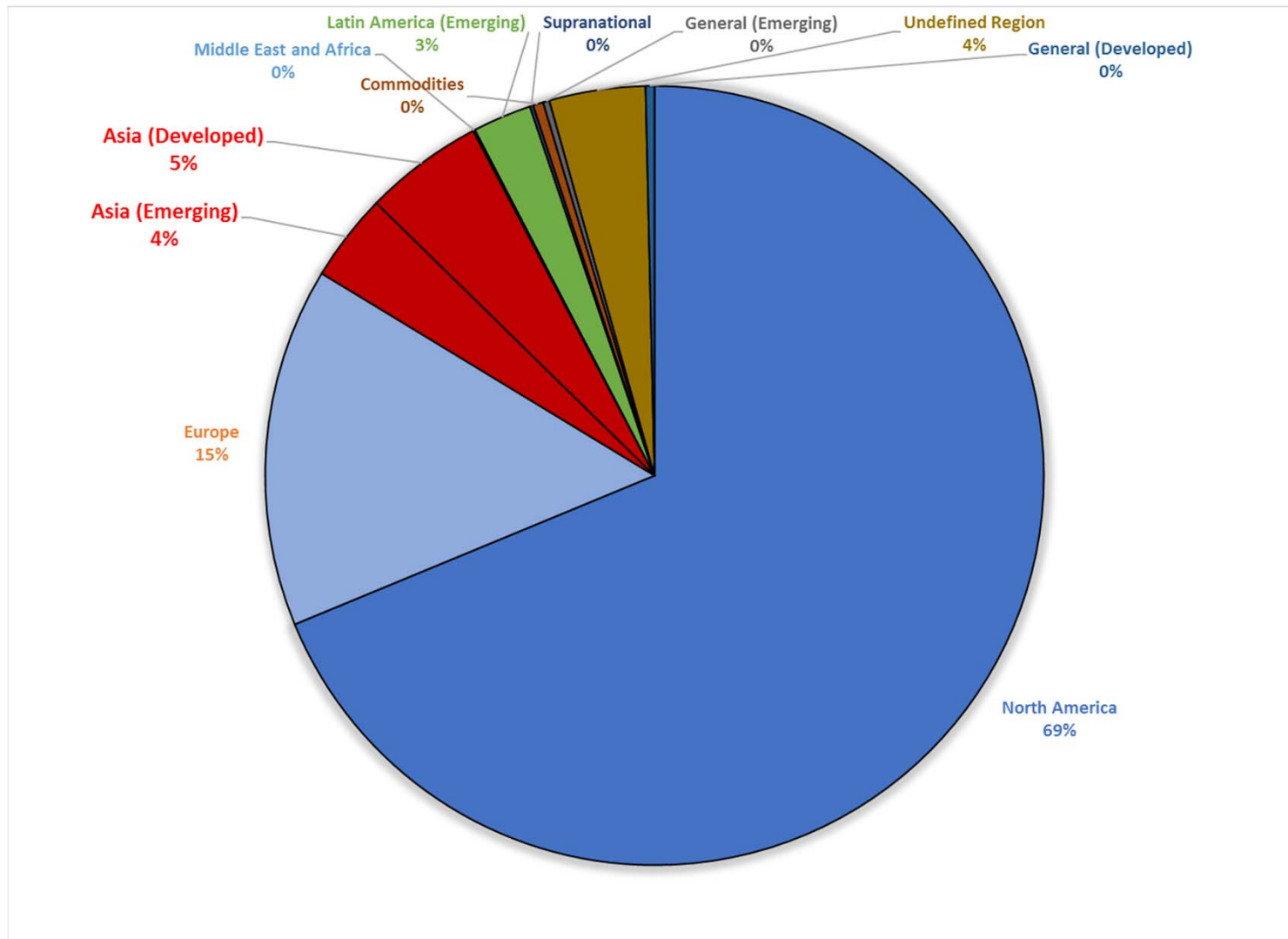
Q3 2019



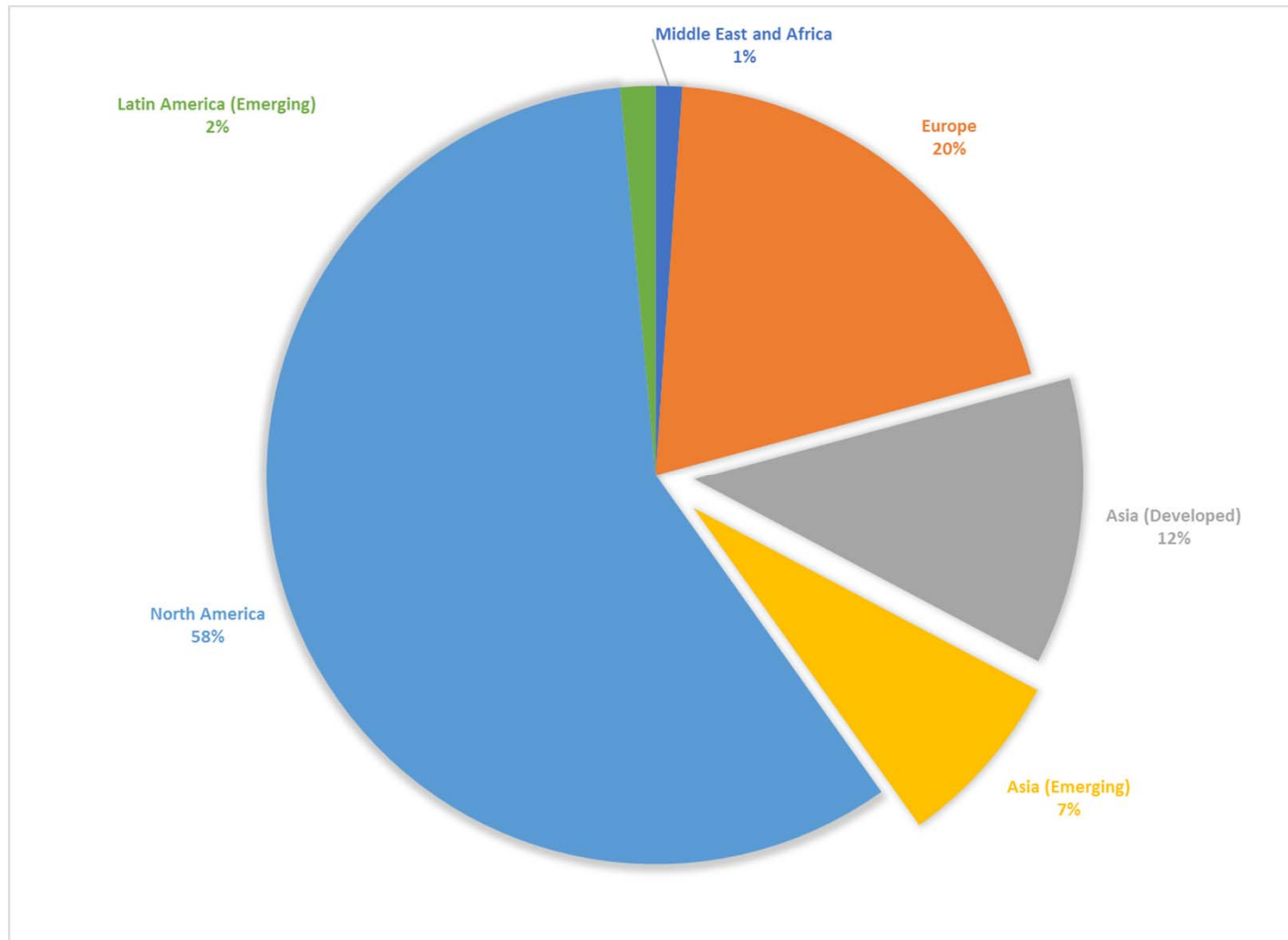
# Outline

- I. Lay of the land
  - Composition of the opportunity set
- II. Why is Asia compelling?
  - Economic and market growth
  - Index inclusion tailwind
  - Active management opportunities
  - China focus
- III. FPPA history in Asia
  - Past and recent activity
  - Current exposure
- IV. Looking forward
  - Current preferences/rules of thumb
  - Considerations to committing to the region
  - Pipeline by portfolio
- V. Appendix

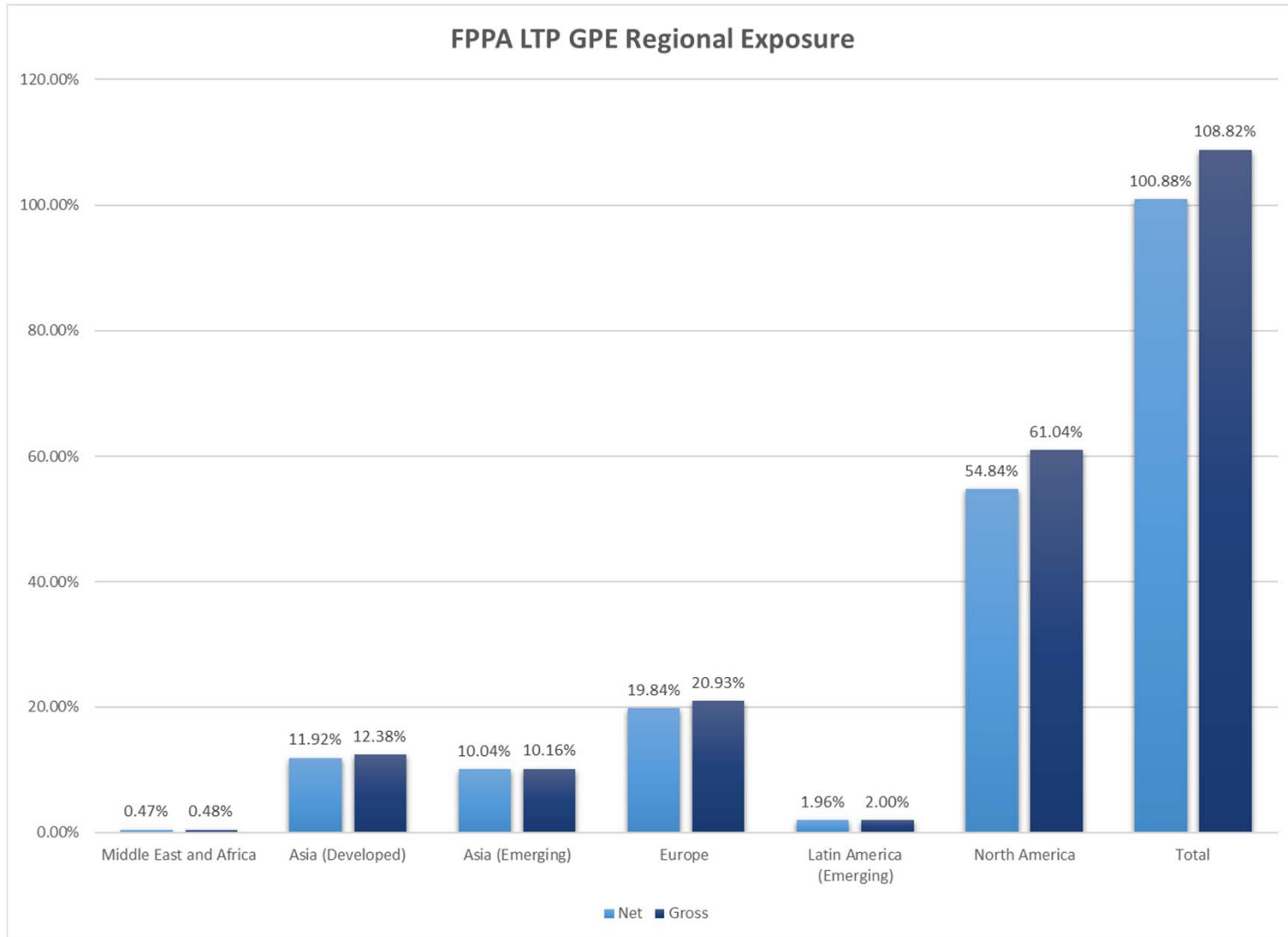
# Introduction: FPPA Total Fund Regional Exposure



# Introduction: MSCI ACWI Regional Exposure



# Introduction: FPPA GPE Regional Exposure



# Executive Summary

## I. Lay of the land

- Asia is composed of a diverse set of countries with varying development, economies, growth rates, and policies
- Asia growth exceeds its DM counterparts
- China is in a class of its own

## II. Why is Asia compelling?

- In a low growth world, Asia offers high and diversified growth across a myriad of metrics
- Asia (and China) are rising in global and regional benchmark representation
- China growth will compel investor attention

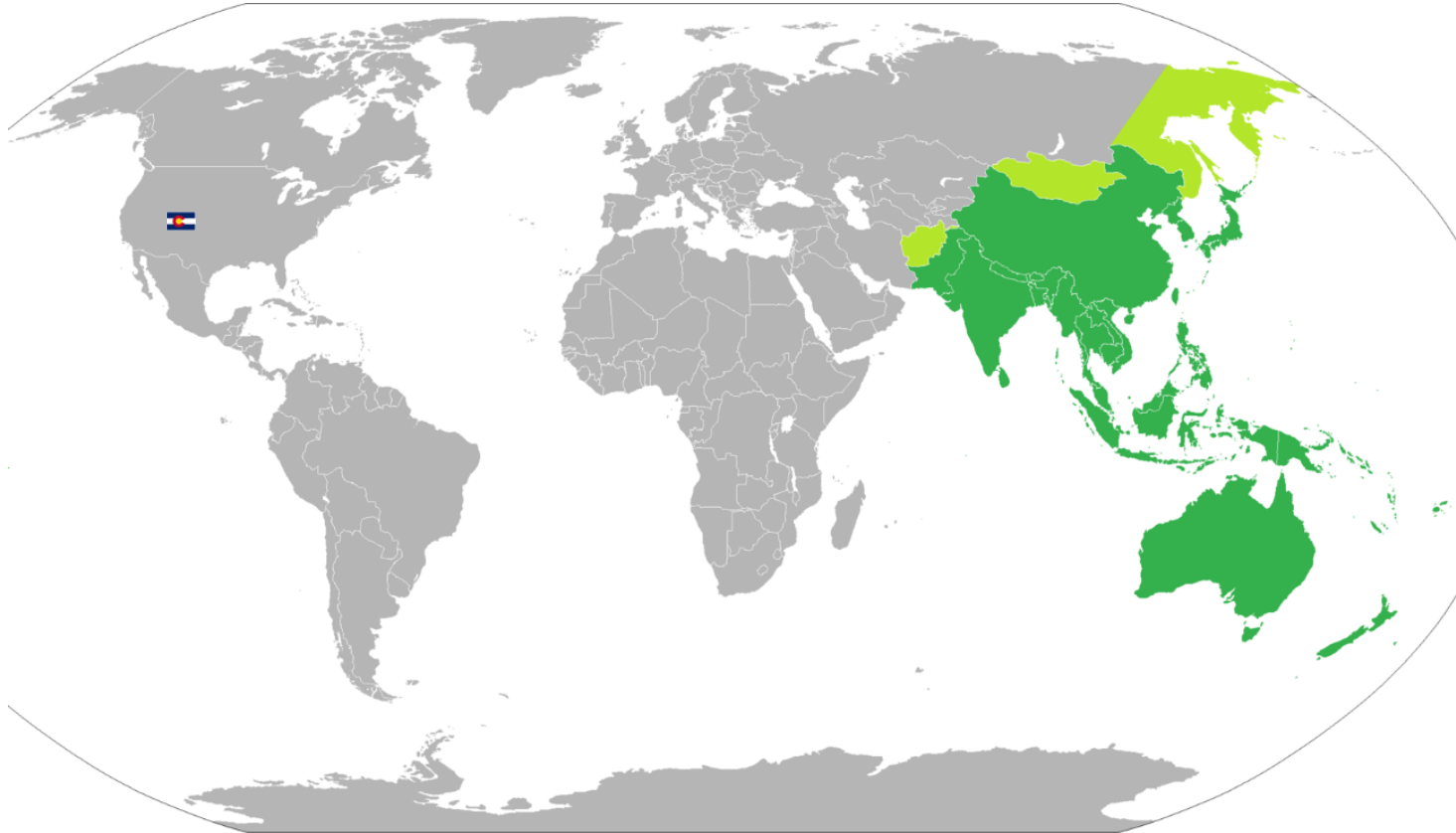
## III. FPPA history in Asia

- Staff has been on the ground at least annually for the past five plus years
- We have current direct and indirect exposure across multiple portfolios, but this is relatively low

## IV. Looking forward

- As ACWI-relative investors, we are likely to gain more Asia and China exposure whether we want it or not
- Staff believes we should seek dedicated Asia (and China) exposure, though we would a) avoid any specific strategic targets, and b) advocate for a gradual and selective approach
- Asia and China present general and specific risks that should be considered
- Staff sees near term opportunities: long only equities, equity market neutral hedge funds

# I. Lay of the Land



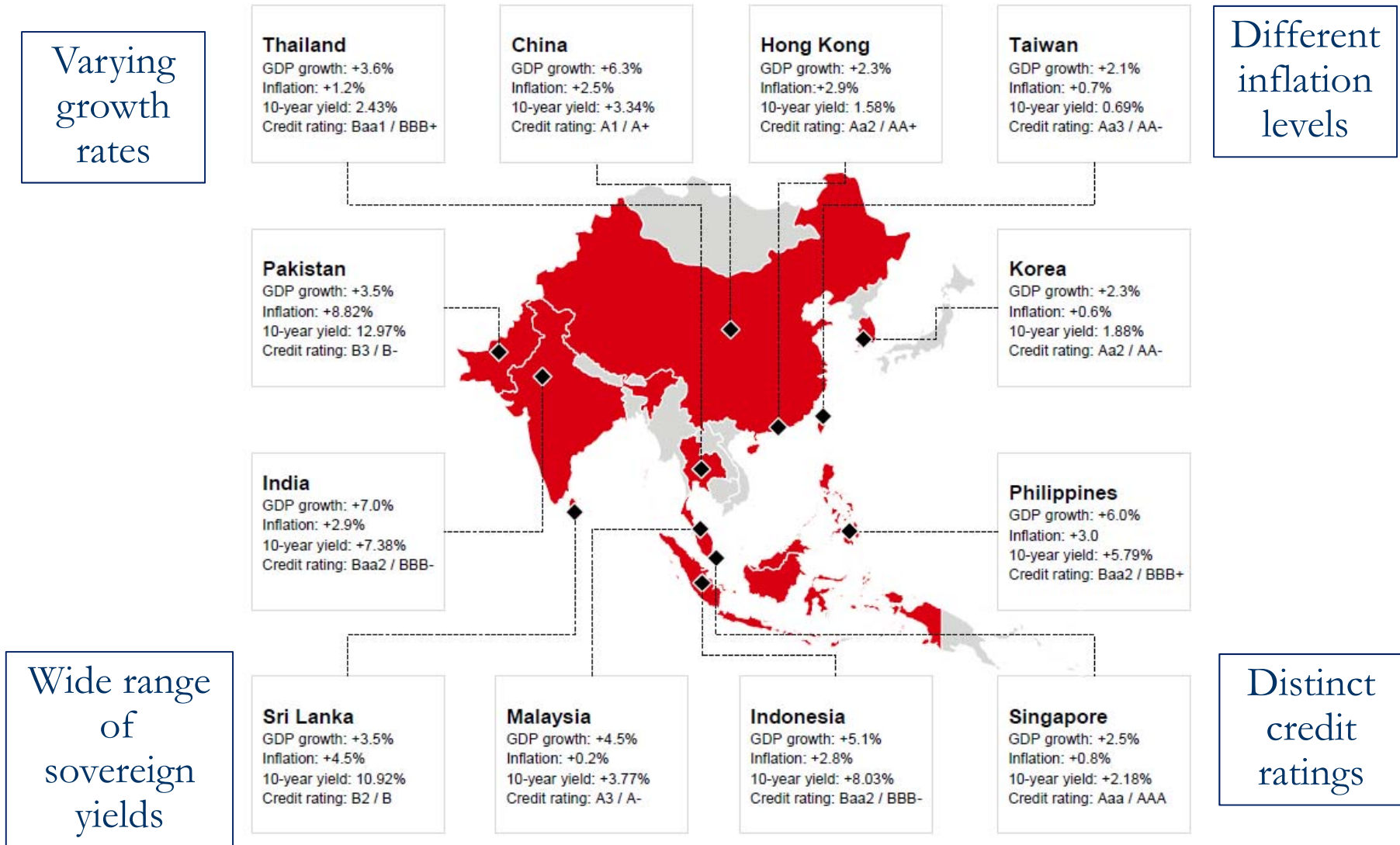
# Quick Facts

*This presentation primarily focuses on “Asia Pacific” which, unless otherwise noted, excludes Japan and Australia*

- 48 countries, including Japan and Australia
- 4.6 billion people = 60% of world population
  - 2.8BN people in China and India alone
  - Asia hold the top six most populous cities in the world; 43% of the population lives in urban environments
  - Asia is home to over 5M millionaires
- GDP = \$32TN (US = \$19.4TN; Eurozone = \$18.8TN)
  - Collective GDP growth rate = 5.7%
  - GDP per capita = \$7,350
- Principal regions:
  - South Asia: India, Pakistan, etc.
  - Southeast Asia: Indonesia, Singapore, Vietnam, Thailand, etc.
  - East Asia: China, Hong Kong, Japan, South Korean, Taiwan, etc.
  - Oceania: Australia, New Zealand, etc.
- Key financial centers:
  - Hong Kong, Singapore, Tokyo, Shanghai, Beijing, Shenzhen, Seoul, Mumbai
- The US has over 45,000 Chinese restaurants, more than all the McDonald's KFC, Pizza Huts, Taco Bells, and Wendy's combined. So that's something.



# I. Asia = Diverse set of economies with...

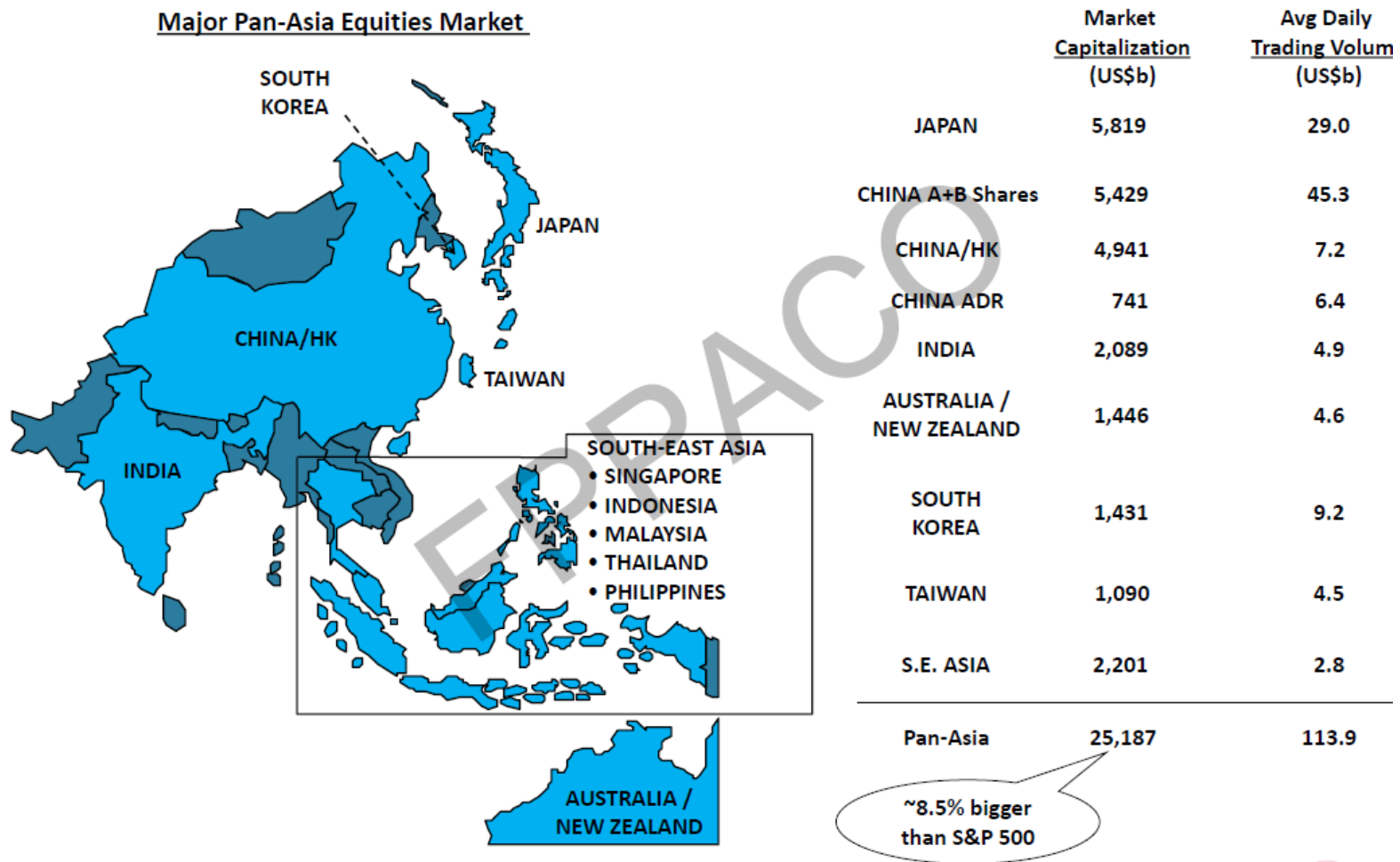


# I. Asia is growing 3X faster than the developed world



# I. Asia equity markets are substantial

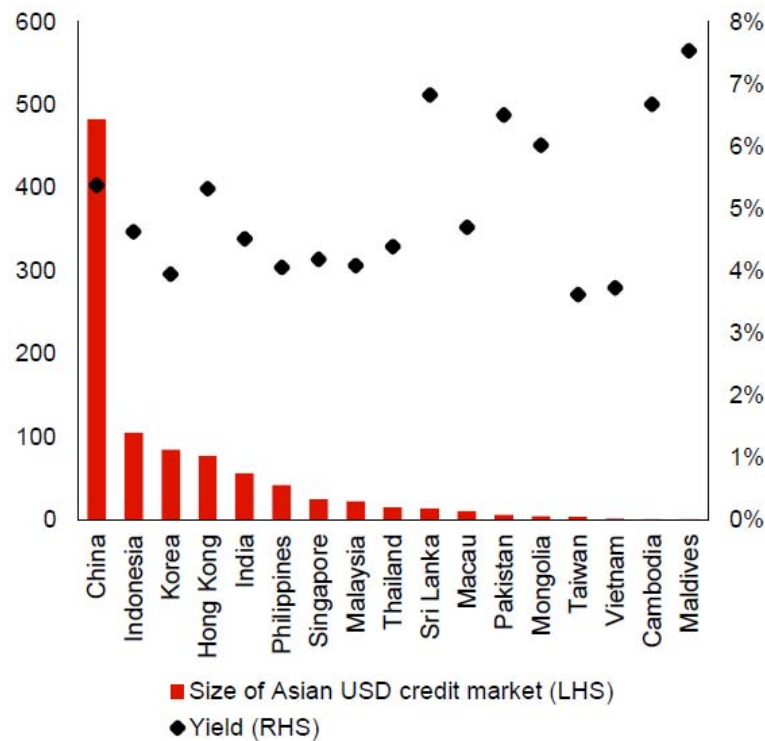
## Asia Markets Are Large and Heterogeneous



# I. Asia Fixed Income Markets: Large and growing

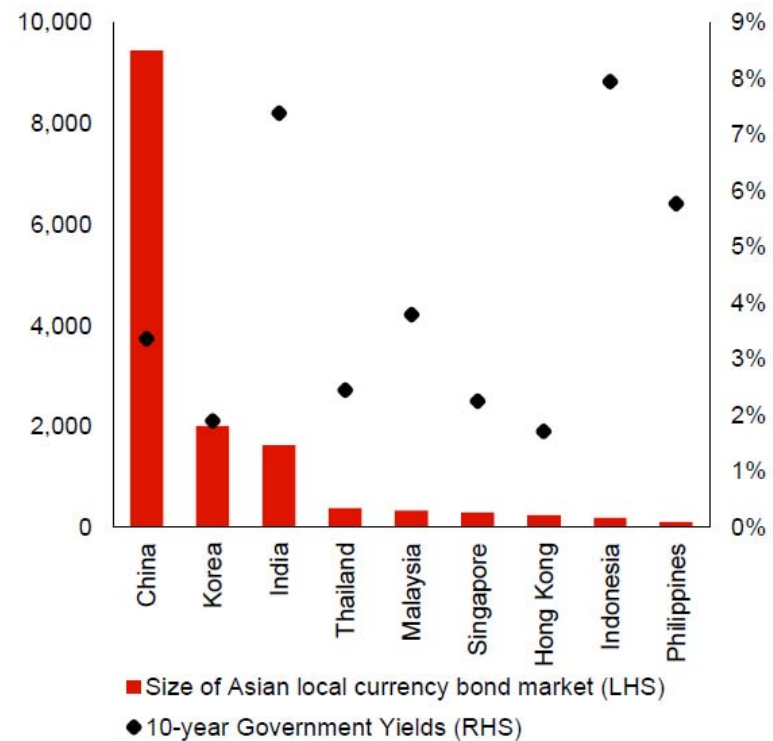
Asian USD Credit Market: \$1TN

(USD billion)



Asian Local Credit Market: \$14TN

(USD billion)



# I. Asia trade and business conditions

Asia already  
trades more with  
itself than ROW



And hosts three  
of the top five  
countries for  
doing business



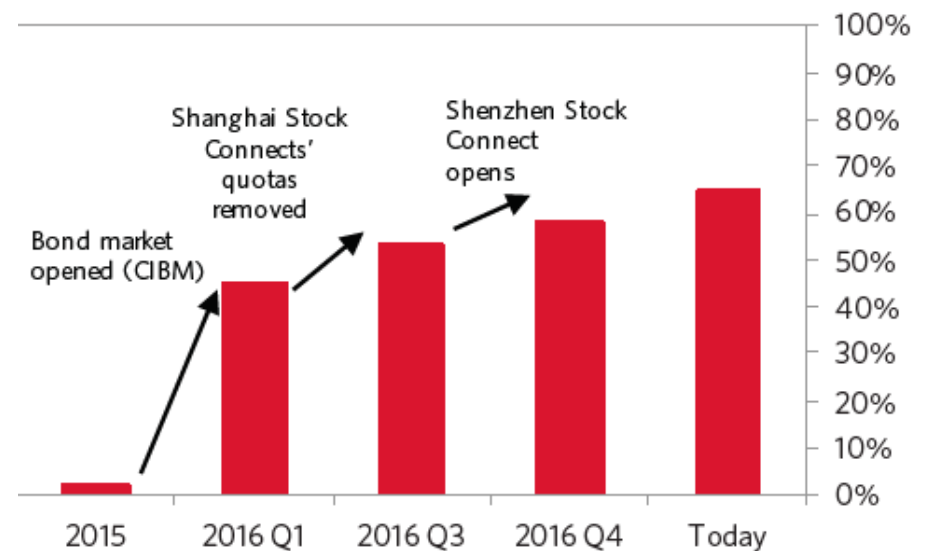
# I. China integration – Markets

## The Opening of China's Equity Markets to Foreigners Has a Long History

1978	China begins implementing reforms to become a market economy
1990	The Shanghai and Shenzhen stock markets open to the public
2002	Qualified Foreign Institutional Investor (QFII) – Select institutional investors are allowed to own A-shares but with restrictions; all transactions are in US dollars
2011	RMB Qualified Foreign Institutional Investor (RQFII) – Foreign investors get more flexibility to transact in RMB with fewer restrictions
2014	Shanghai–Hong Kong Stock Connect – Gives foreign investors near free-flow movement into and out of A-shares as long as the connect is within its daily trading limit
2016	Shenzhen–Hong Kong Stock Connect – Connection to Shenzhen offers foreign investors more options, especially in “New China” companies (e.g., tech, health care)
2018	MSCI Inclusion – Scaling up of a successful stock connect model, which encourages foreign benchmark-aware managers to invest in China

## Domestic Chinese Asset Markets Accessible to Foreign Investors

(% of Total Assets)



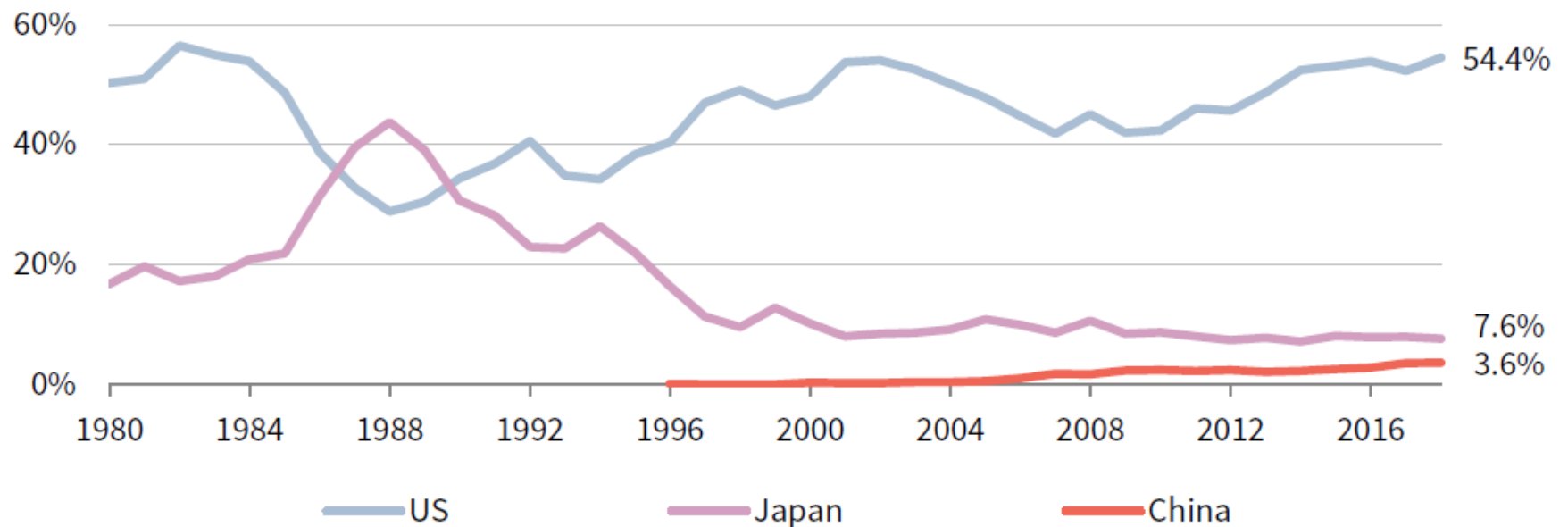
# I. But China equities are underrepresented in indices

Onshore



MSCI ACWI

China = Onshore + Offshore



# I. China Fixed Income

Figure 1: Bond market size (US\$ trillion)

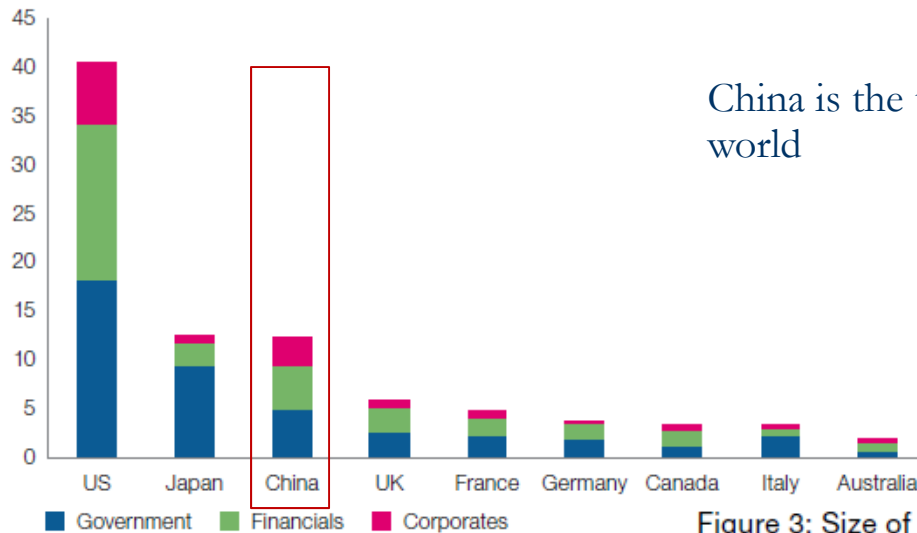
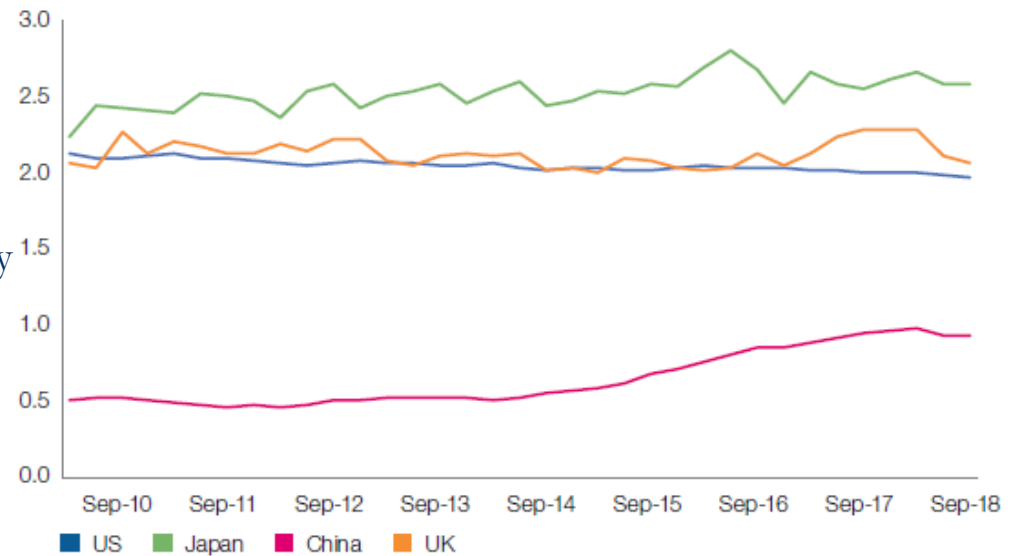


Figure 3: Size of bond market relative to nominal GDP (multiples)



Despite the credit growth, China remains materially underleveraged relative to DM economies



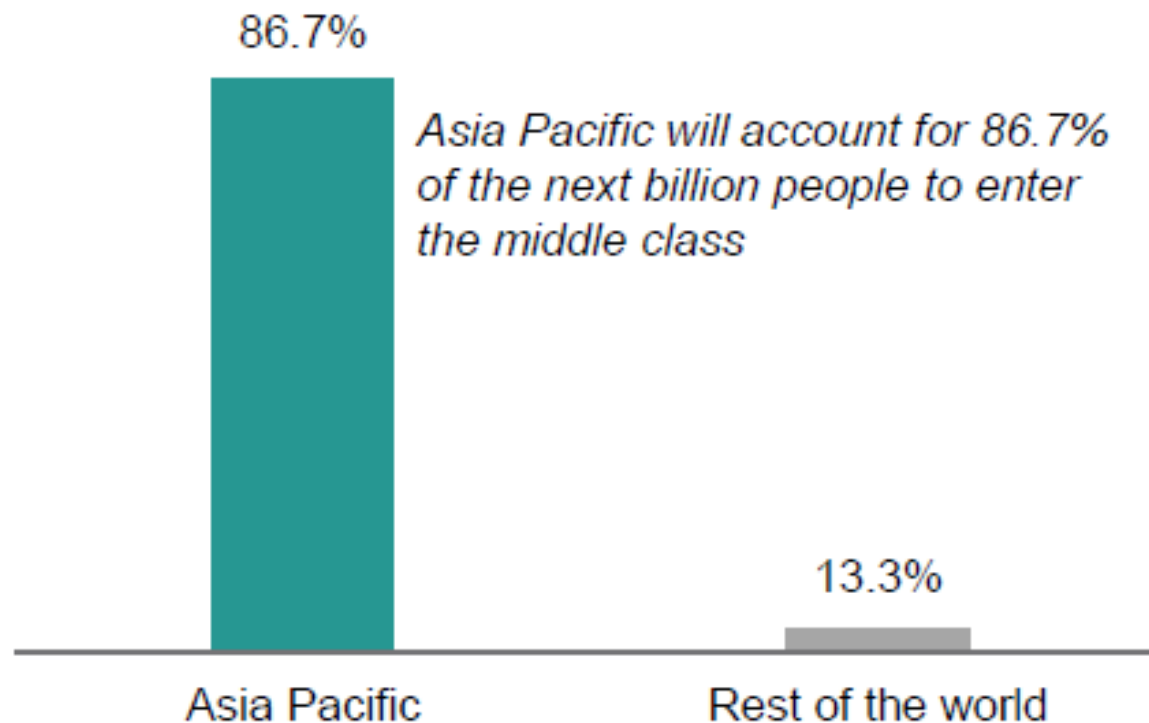
## II. Why is Asia Compelling?



## II. Asia is where the middle class is growing

### Asia will dominate the middle class

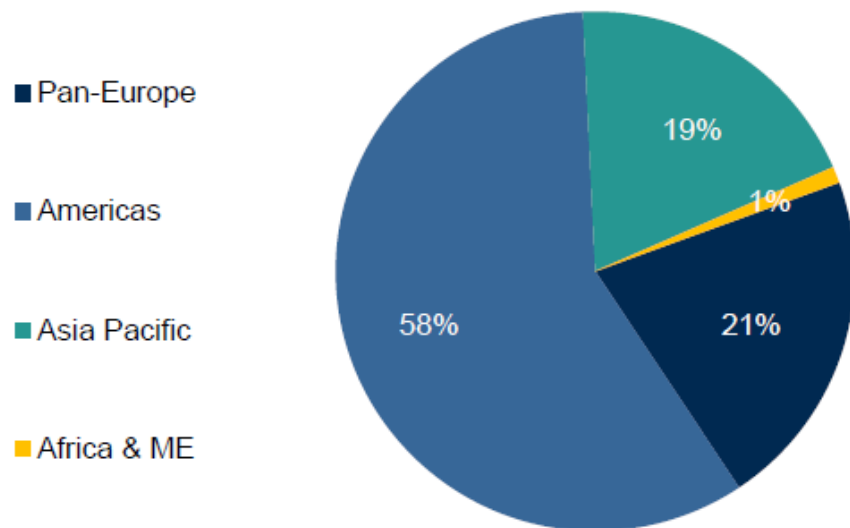
Breakdown of the world's next billion middle class entrants



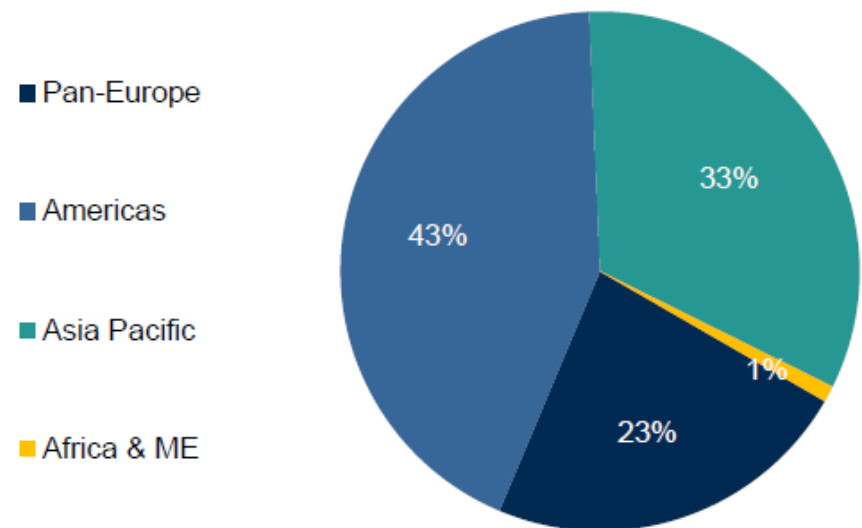
## II. Current index weight $\neq$ Revenue contribution

Figure 3: Comparing MSCI ACWI weights

MSCI ACWI regional weights  
by market cap

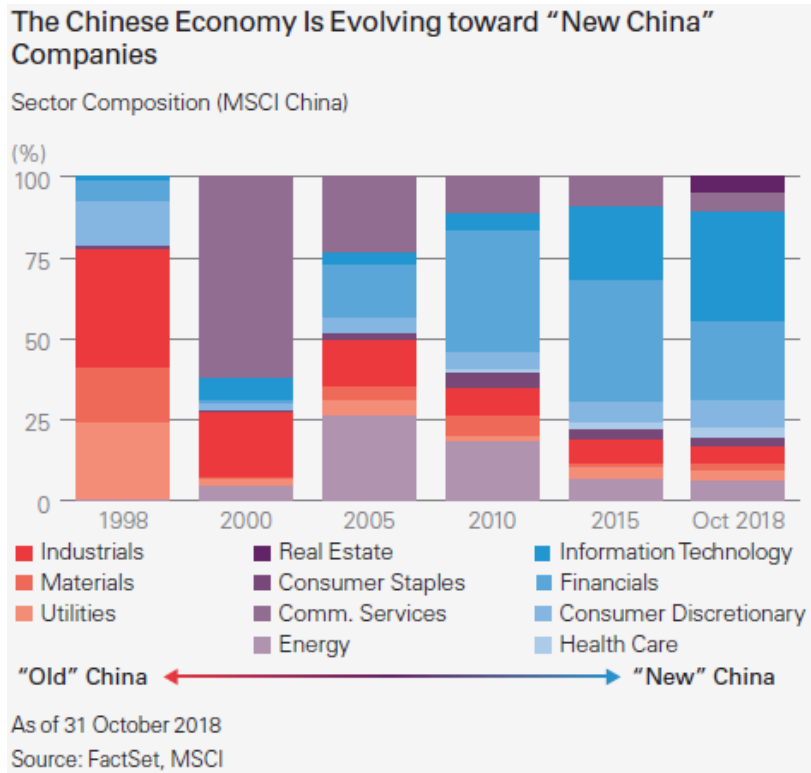


MSCI ACWI regional weights  
by revenue



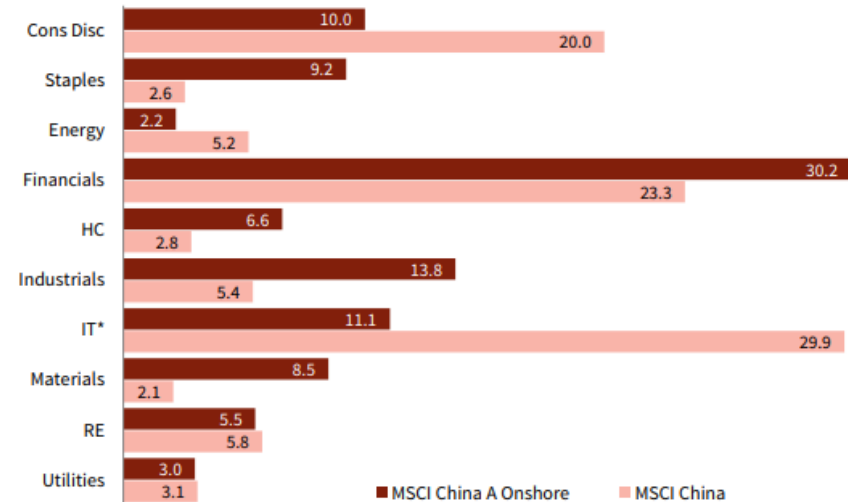
Asia is less than 20% of the ACWI despite contributing a third of total revenues

## II. China evolution → onshore ≠ offshore equities



### CHINESE EQUITIES SECTOR COMPARISON

As of December, 31 2018



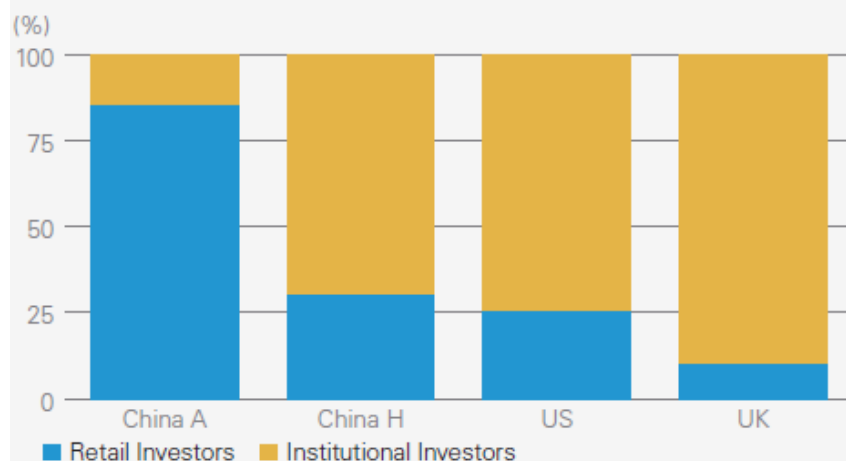
\* IT sector includes Communication Services and Information Technology.

Sources: FactSet Research Systems and MSCI Inc. MSCI data provided “as is” without any express or implied warranties.

## II. A Share Competition

### Chinese Retail Investors Account for Most China A-Share Trading

Turnover Contribution by Investor Type

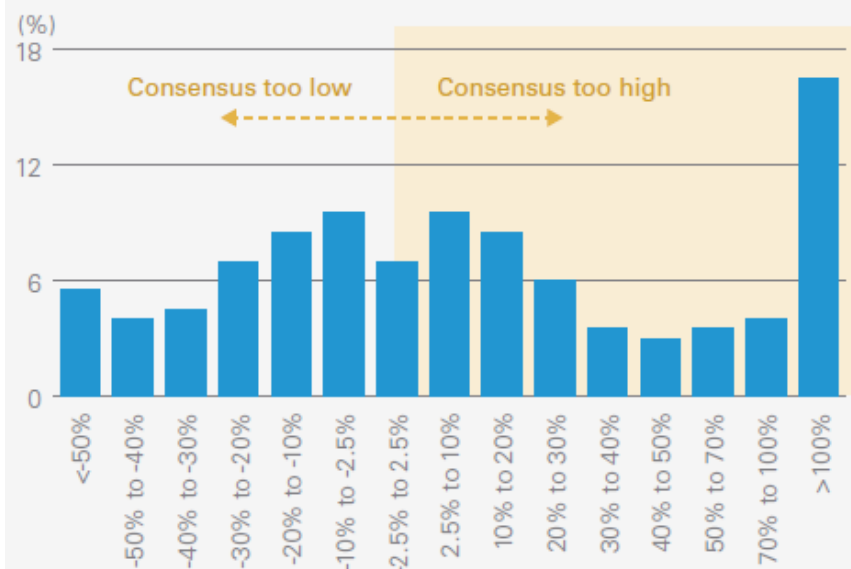


As of 1 May 2018

Source: South China Morning Post, 1 May 2018, <https://www.scmp.com/business/money/markets-investing/article/2144194/global-investors-take-their-positions-ahead-chinas>

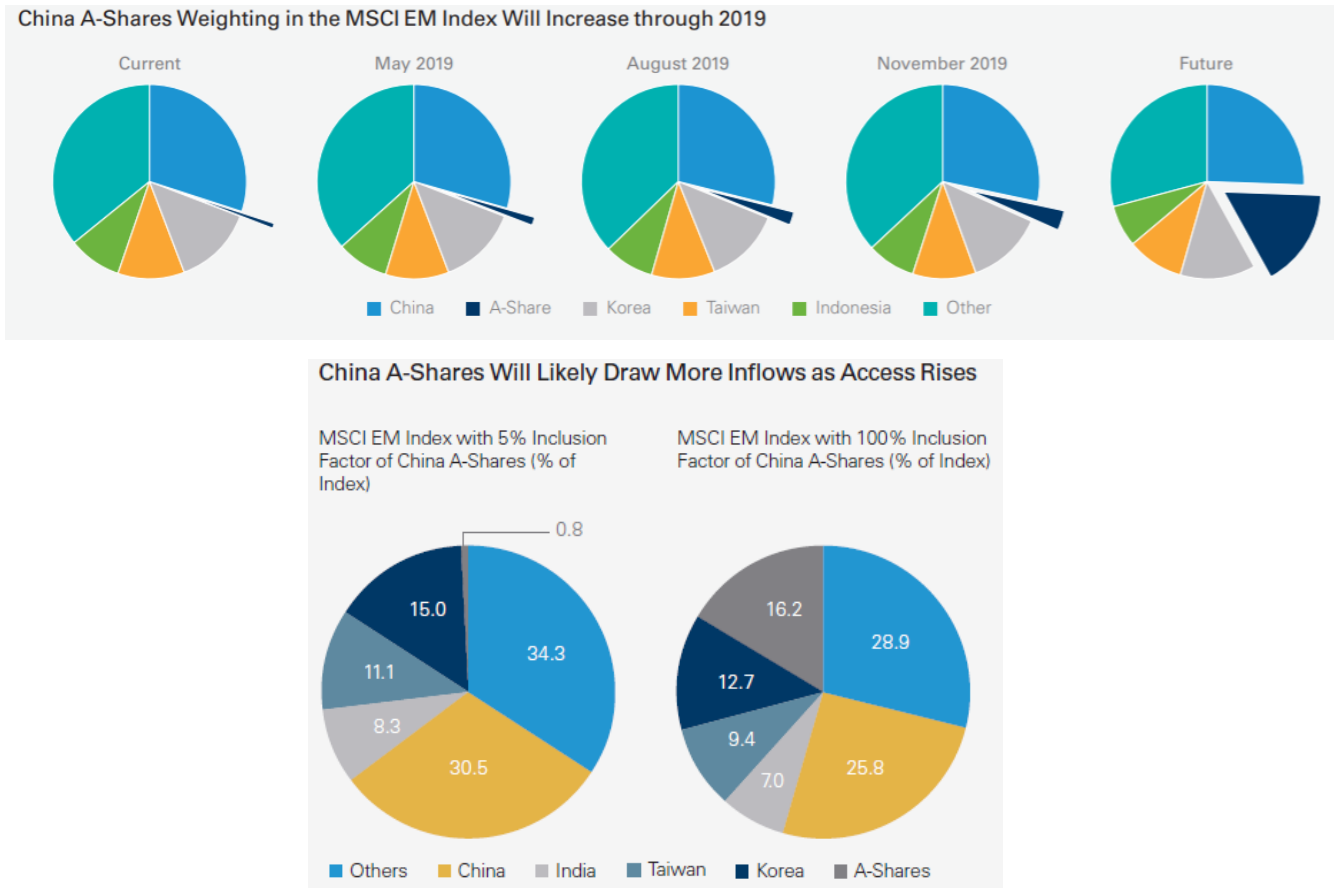
### A-Share Consensus Tends to Be Extreme and Less Accurate

A-Share Consensus at the Start of Each Year Compared to Actual Earnings from 2013 Onwards



Within 500 largest stocks by market cap

# I. China A-Share reweighting is already happening



Punchline: As long as we have passive equity exposure, we're going to get China whether we like it or not

### III. FPPA History in Asia



FPPA legacy slide deck template



What comes up when you Google “Asia hiking cartoon”

### III. FPPA in Asia

Staff has been in the region at least annually since 2015:

Date	Analyst	Location	Agenda
Apr-15	JH	Hong Kong	Region/manager research
Oct-16	JH	Singapore	Albourne conference
Nov-17	JH	Hong Kong	Manager research
Mar-18	JH	Hong Kong	Manager research
May-19	JH	China and Hong Kong	Company research with Yiheng
Jun-19	BB	Hong Kong and Singapore	Region/manager research

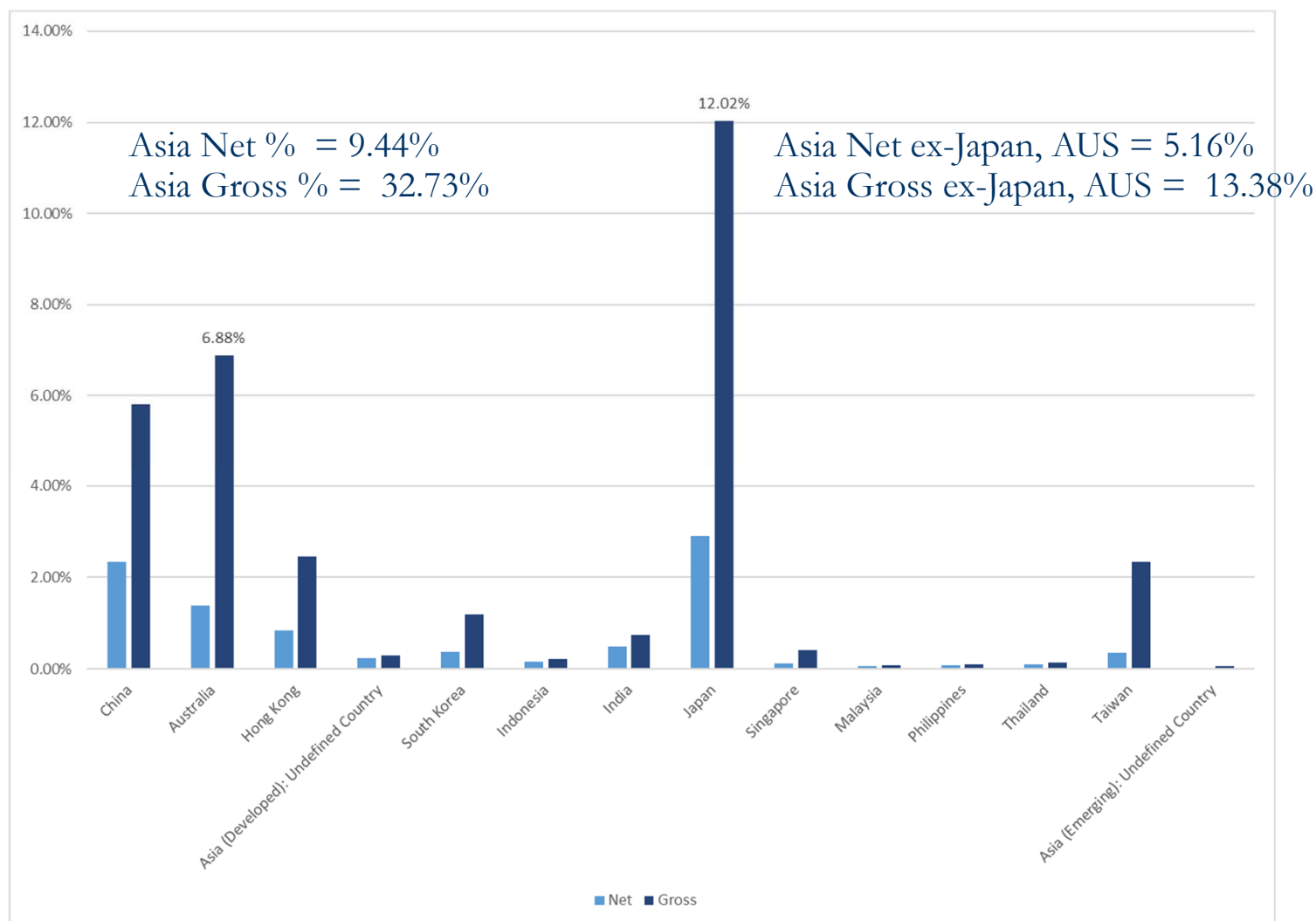
FPPA relationships with strategic presence in Asia:

- Cambridge
- DE Shaw
- WorldQuant
- SSGA
- Yiheng
- Manulife
- Alphadyne
- Citadel
- Autonomy
- Pharo
- Prudential

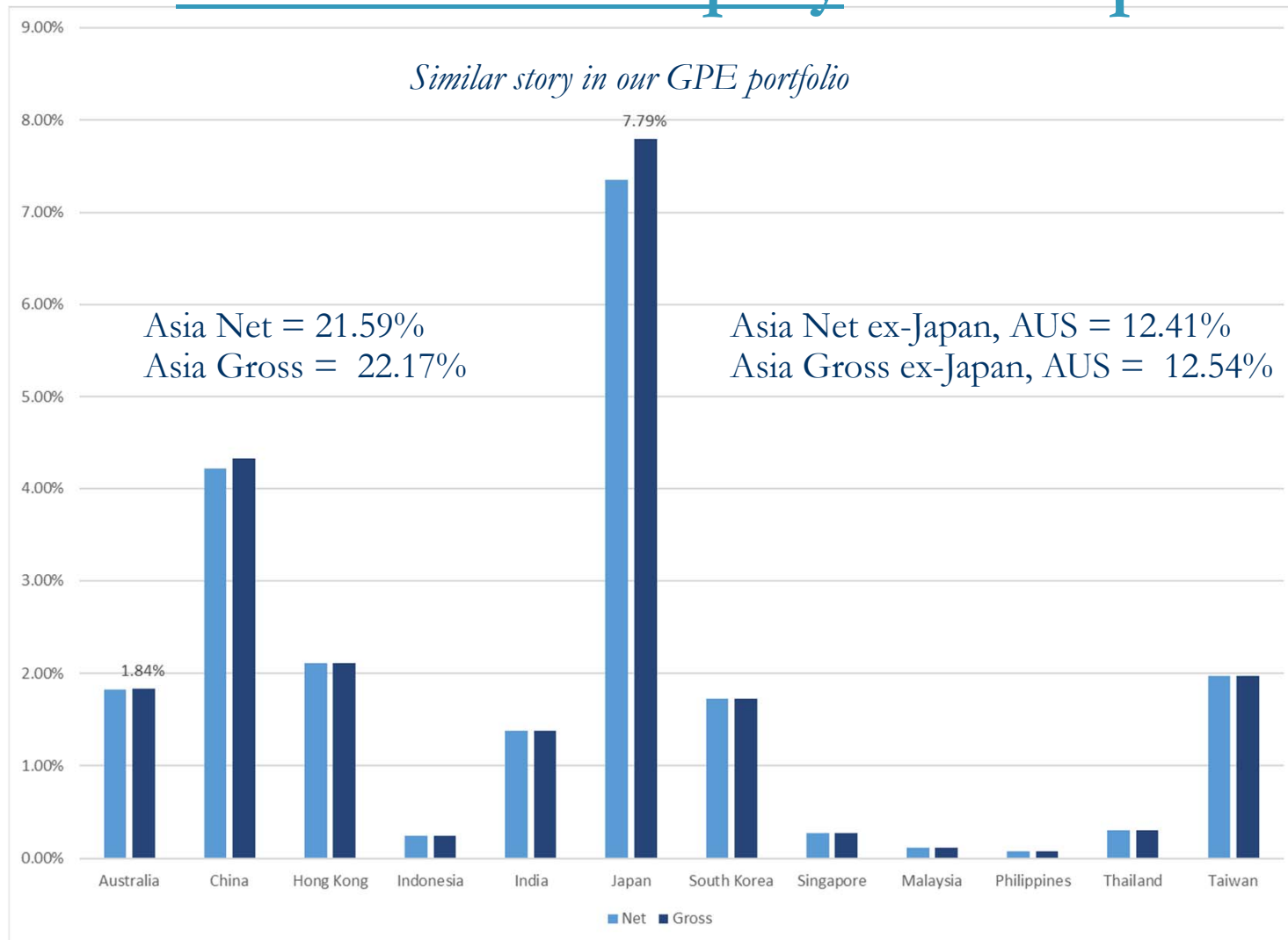


# III. FPPA Total Fund Asia Exposure

*FPPA currently has modest direct Asia exposure, although this is much lower if one excludes Japan and Australia*



### III. FPPA Global Public Equity Asia Exposure



## IV. Looking Forward



# IV. Initial Observations and Preferences

- Asia  $\neq$  one uniform “beta”
  - Diverse set of underlying economies and markets
  - Many countries have a high composition of retail and local investors
  - It is difficult to comprehend to the sheer scale of the opportunity set without being on the ground in the region
- Asia offers appealing:
  - Diversification to existing portfolio holdings
  - Growth and valuation prospects relative to DM
  - Inefficient markets can lead to active management opportunities
- Asia is currently underrepresented in our portfolio
  - This will only increase as the region (and China) are further integrated into the global economy
- Asia brings passive and active opportunities...but there is an awful lot of junk
  - Reward for active management in certain areas...but,
  - Investments should be complementary, not simply “good alpha in a bad beta”
- Gradual, case-by-case exposure
  - Consider each opportunity in the context of its intended portfolio
  - No need to race to a “strategic target/weight”
- Medium term, consider China as its own allocation
  - “Asia ex-China”
  - Funded from EM with MSCI EM and MSCI ACWI IMI as considered “cost of capital”

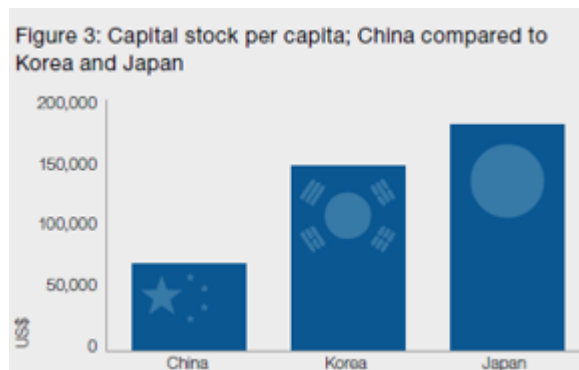
## IV. Looking Forward

- LST believes FPPA should selectively embrace dedicated Asia and China exposure
  - Asia and China will have a growing role in passive benchmarks
  - While total exposure will generally be driven by the bottoms, rough guidelines may include:
    - Limits to relative overweights versus MSCI ACWI IMI
    - Total exposure limited to 10-15% of Total Fund → Example: Cambridge suggests 5-10% for China alone
- Staff currently sees opportunities in long only equities and equity market neutral hedge funds (hold this thought)

# IV. Considerations – Is China Stable?

*China has systematically pursued a strategy of global economic, equity, and currency, integration*

- Is China's investment rule of law trustworthy?
  - China continues to improve its regulation and integrity of capital markets (Cambridge, March 2019)
  - China is focused on improving its international standing; observance of contractual obligations of foreign parties is central to this
  - Despite the trade rhetoric, China has repeatedly pledged to follow through on rule of law questions, most recently reaffirmed its support for replacing existing regulations for joint ventures and wholly foreign owned enterprises (Source: [Reuters, March 2019](#))
- Could China impose capital controls?
  - While China limits what its citizens can take out of the country, it has never done so to foreigners
  - More recently, China is moving towards a structural deficit which would require over \$200BN of net foreign capital inflows from 2019 to 2030 to fund (source: Morgan Stanley, March 2019); any gating activity would demolish their progress
- Could China pursue expropriation?
  - Expropriation would occur in key domestic companies or industries; foreign ownership is limited here
  - Foreign divestment > expropriation
- Could China suffer from over-indebtedness?
  - China has strong tools to manage debt, from internal capital controls to a state-owned banking system
  - Total China leverage (slide 18) and capital stock (see below) is low compared to DM



## IV. Considerations – Specific

- Resource commitment
  - Time difference (+12-14 hours) poses monitoring challenges
  - Importance of being on the ground → Recommend 1-2 trips per year
- Select opportunities may require ability to react quickly
  - Asia managers have lower capacity and are apt to close more quickly than DM counterparts
- Importance of monitoring total Asia exposure
  - Direct: Current managers with ability to invest in Asia (EM managers)
  - Indirect:
    - US-listed Asia companies (e.g. Alibaba, JD.com, etc.) are often confused with DM
    - DM managers with select Asia exposure (Walter Scott, Sachem Head, etc.)
    - Underlying investments with pass-through Asia exposure (e.g. European exporters)

# IV. Due Diligence Priorities

## Near Term

- Global Public Equity
  - Janchor
- Fixed Income
  - None
- Long Short
  - None post-Yiheng
- Absolute Return
  - Equity market neutral

## Medium Term

- Global Public Equity
  - Dedicated China
  - Consider EM upgrades
- Fixed Income
  - Consider dedicated Asia (IG)
- Long Short
  - Janchor Long/Short
  - Consider select long/short strategies
- Absolute Return
  - Global macro, multi-strategy



# Conclusion: A borrowed framework for Asia/China asset allocation

