How To Get Comfortable With Chinese Equities

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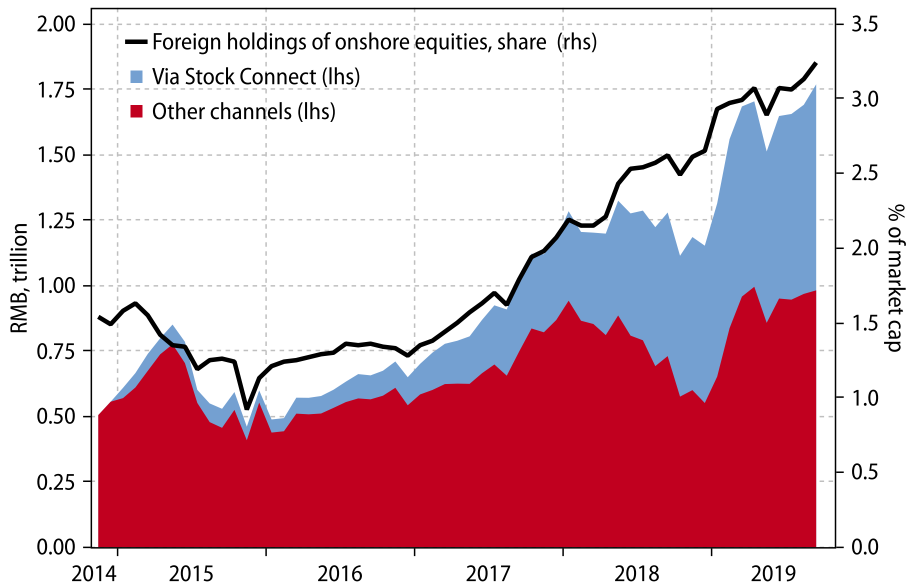
Global investors are getting increasingly comfortable with China's onshore stock markets. Over the past two years, foreign investors' holdings of Chinese A-shares have roughly doubled, to 3.2% of the local market cap from around 1.5%. The big driver of this rising interest has been the decision by MSCI and other index providers to add Chinese onshore stocks to their benchmark indexes, moves that recognize China's substantial steps to increase access to its local markets. The third stage of MSCI's gradual process took effect this week, capping a year in which in which the weight of onshore Chinese equities in its flagship MSCI Emerging Markets index quadrupled to 4.1%. But MSCI inclusion does not mean that China's stock market has become just like its global peers.

The success of the Stock Connect schemes has opened up China's onshore markets to more foreign participation

The success of the Hong Kong Stock Connect schemes, which allow any investor with a brokerage account in Hong Kong to trade Shanghai- and Shenzhen-listed shares, is the basis for the welcome given to onshore equities. The Connect schemes account for almost all of the increase in foreign investors' onshore holdings since 2017, and their flexibility has given MSCI and its customers the confidence to boost onshore stocks' weighting in its global indexes. MSCI's latest move added 204 A-shares to the index, bringing the total to 472. The "inclusion factor," a discount on the market-cap weight of onshore stocks in the index, has also risen to 20% from 5% at the beginning of 2019.

Foreign holdings of onshore stocks have roughly doubled over the past two years as index inclusion moved forward

China's onshore stock markets are becoming more accessible to investors



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Index inclusion has catalyzed greater interest from active investors, not just driven passive flows

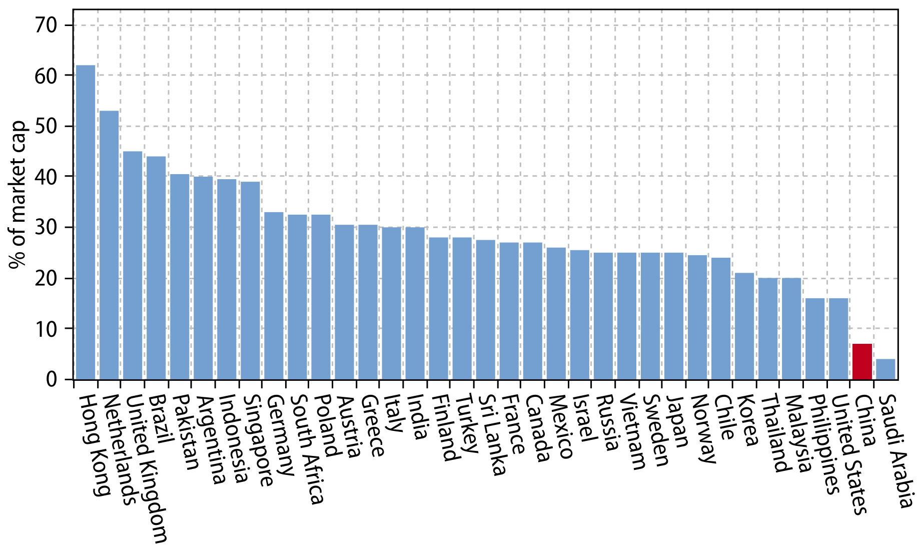
Those changes have driven some passive buying of onshore Chinese stocks from funds that mechanically track indexes. But the bigger effect has been to catalyze greater interest in onshore equities among active investors. The fact that foreign inflows have generally front-run the index inclusion dates, and that inflows are concentrated in specific firms rather than spread broadly among index constituents, shows that active investors actually account for most of the new inflows. MSCI's imprimatur essentially means that it has judged that foreign investors will be able to put money in and take money out of China's onshore equity markets without major problems.

It is still very early days for foreign ownership of China's onshore equities

But it is still very early days for foreign investment in onshore equities, and China's market has far less foreign participation than virtually any other emerging market: for most countries foreign investors own at least 20% of the market cap (see chart). For foreign investors to truly get comfortable with Chinese equities, they need to be familiar with the numerous idiosyncrasies and risks involved in investing in onshore stocks that have not been addressed by index inclusion.

Foreign ownership of Chinese onshore equities is extremely low

Stock market holdings by non-domestic investors, 2017



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The volatility of the CSI 300 is more than three times higher than the S&P 500

Volatility and leverage. China's onshore equity markets are much more volatile than other major markets. Since 2006, the standard deviation of returns for the CSI 300 large-cap index is 38%, more than three times higher than the 11.6% for the S&P 500. One reason for this is the very low level of institutional holdings in the market. The OECD reports that only 9% of onshore Chinese market cap is owned by institutional investors, compared with 72% in the US, 37% in Japan and 25% in Brazil. In addition to providing stronger checks and balances on corporate governance (more on that later), institutions tend to be longer-term and more stable shareholders relative to retail investors who flip their holdings more frequently. China's onshore equity markets average monthly turnover of 17% of market cap, against 8% for US markets.

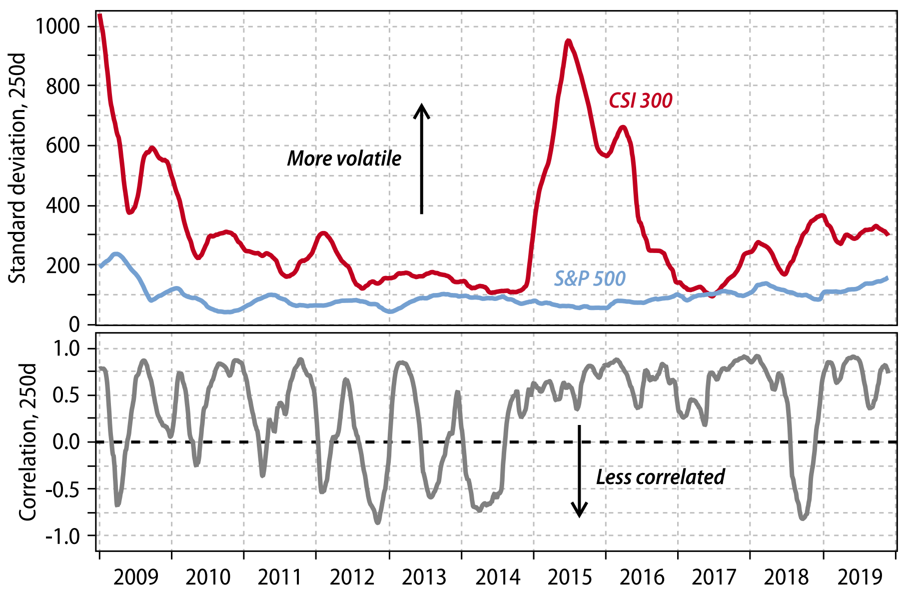
The other cause of the incredible volatility of onshore equity markets is the very high level of leverage. The infamous 2015 bull market and subsequent crash was driven by margin financing on the way up, and on the way down, as regulators' move to restrict the opening of new margin accounts was the catalyst for the bubble bursting. In 2018, equity pledge financing, also known as share pledging, took center stage as the source of chaos. As private firms lost access to shadow financing in the financial-regulatory crackdown, large shareholders pledged their stock as collateral at brokers in exchange for loans to ease their firms' liquidity problems. When stock prices declined, investors began to worry that margin calls would lead to forced sales of these stocks. Since then the issue has receded from the headlines: the proportion of shares that are pledged has fallen, though it remains elevated, and progress in US-China trade talks and easing of monetary policy have pushed stock prices higher. Nonetheless, leverage has a way of finding its way into China's equity market, as it does into real estate, and any hint of a new cycle of leveraged buying and regulatory crackdown should be monitored carefully.

Very high levels of leverage, among both stock traders and company insiders, are a big factor behind this volatility

While the volatility of Chinese equity markets is not a new phenomenon, for a long while it was balanced out for international investors by the fact that correlations with global markets were very low. As part of a global portfolio, onshore stocks were a valuable source of diversification and raised risk-adjusted returns despite their high volatility. Over the last few years, however, this diversification benefit has faded, as onshore stocks have moved more in sync with global markets.

Chinese equities have become less of a portfolio diversifier as they grow more correlated with global markets

Low correlations no longer offset China's higher volatility



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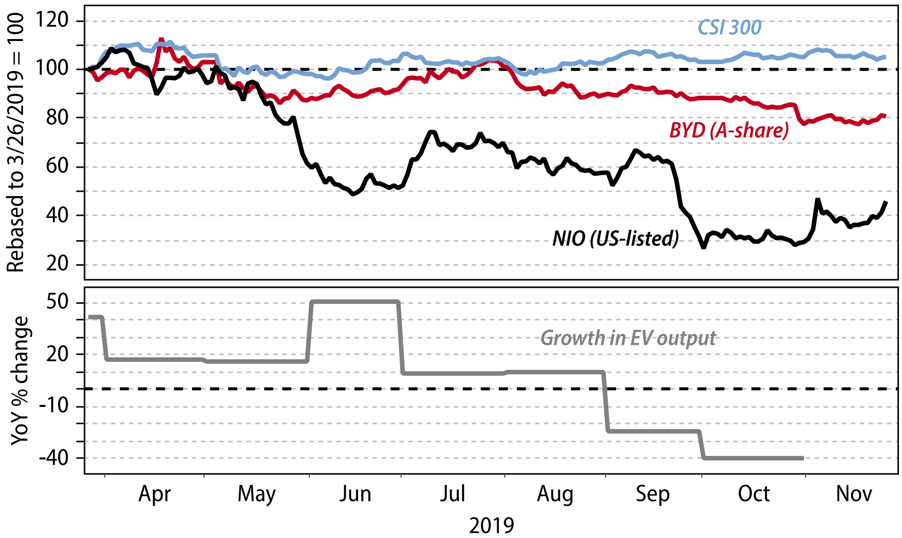
Political and regulatory risk. It is always worth remembering that Chinese listed firms are subject to the whims of the world's most comprehensively interventionist government. China's policymaking and regulatory frameworks are opaque, unpredictable and can materially change the market environment quite quickly (see **A User's Guide To The Chinese Stock Market** for a comprehensive breakdown). One recent example: in March, the Ministry of Finance unexpectedly reduced its extensive electric vehicle subsidies, halving them in 2019, and phasing them out entirely for 2020. Since then, BYD's share price has underperformed the onshore market by 25%, while US-listed Nio is down 60%.

Policy changes on electric vehicles show how Chinese stocks are subject to changing government whims

EV stocks have plummeted since subsidies were curtailed

Performance since MOF EV subsidy announcement on March 26



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The more general point is that Chinese policymakers are always adjusting their plans, and even attempts to address obvious problems frequently produce unintended consequences. Perhaps the most important of these unintended consequences right now is the liquidity squeeze on private-sector firms. The tightening of financial regulation that began in 2016 was a rational way to control the growing off-balance sheet risks in the financial system. But as it has progressed, the regulatory crackdown has led to sharp declines in the volume of shadow financing, which means an ongoing liquidity crisis and rising refinancing risks for the mostly privately owned firms reliant on this financing.

US-China trade tensions have also made the US government a source of political and regulatory risk for Chinese firms

The tensions in the US-China relationship have also made the US government a source of political and regulatory risk for Chinese firms. The Trump administration has imposed tariffs and export controls that are disrupting markets and supply chains—though many Chinese companies, including electronics giant Huawei, have found that the sanctions do not pose an existential threat (see **The Weakening Bite Of US Tech Sanctions**). Nonetheless, with the situation in Hong Kong inflaming tensions, the progress toward a trade truce facing some major roadblocks, and no-one in the US political establishment speaking up against anti-China sentiment, it seems the political risk from the US for Chinese listed firms will only get more severe over time.

One potential channel for this impact could be the rising importance of the "environmental, social and governance" agenda, or ESG. As the world's biggest builder of coal-fired power plants, China has a number of companies that could raise alarms for environmentally oriented investors. The participation of private companies in some military and domestic security projects could also make them tricky for foreigners to invest in (see **A Military Embrace Brings Risks For Technology**). Investors in Hikvision, a provider of surveillance equipment and software, have already faced pressure to divest from the company because for its involvement in the mass detention of Muslim minorities in Xinjiang province.

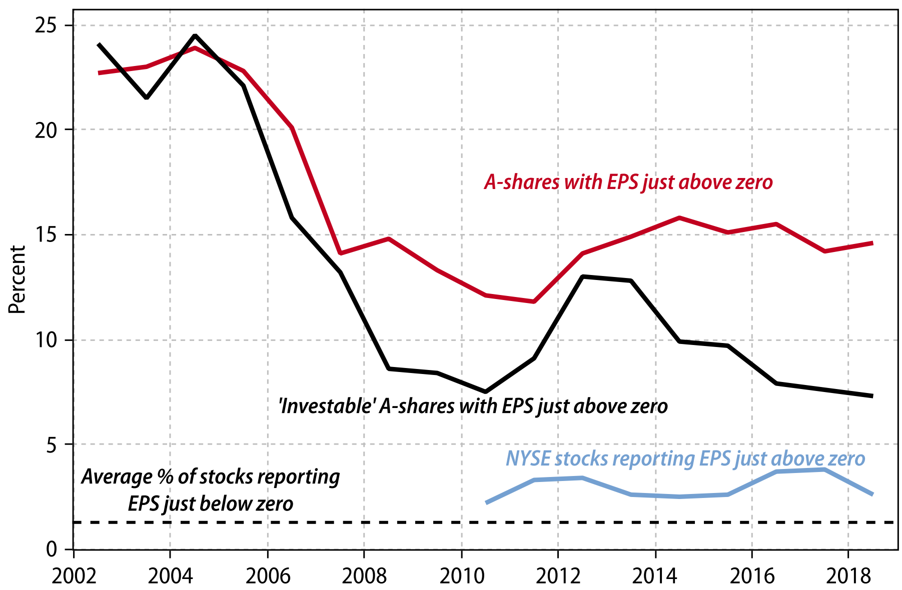
Chinese corporate governance is poor, and statistical evidence suggest falsified earnings are relatively common

Corporate governance. It is not news to anyone that corporate governance in China substantially lags that in developed markets. In 2019, accounting scandals surfaced in droves, and skepticism about the reality of the results reported by Chinese listed firms runs high. One simple statistical test for earnings manipulation is to look at how many firms report EPS just above zero compared with just below zero. As typically around 1% of firms report EPS just below zero, a normal distribution of earnings would mean 1% of firms also report EPS just above zero. In fact, in the early days of the onshore markets, 20-25% of firms reported EPS just above zero, a sign that falsification of results was widespread.

The problem is only somewhat less severe today. Larger companies do, however, seem to be of higher quality: for the roughly 400 A-share stocks that have sufficient size and liquidity to be relevant to international investors, the share of firms reporting EPS just above zero has fallen more, and is still trending down. Regulators are also on the case, with the China Securities Regulatory Commission recently releasing new measures to improve information disclosure, standardization of governance and the coordination of regulatory agencies, to boost listed firms' reporting and compliance.

For larger and more investable companies, governance has improved more, but still lags developed markets

Corporate governance has improved, but remains shaky



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One aspect of Chinese corporate governance which will remain fundamentally different is the relationship of management and shareholders. The cult of maximization of shareholder value, which has had much influence in boardrooms of US companies, does not have the same force in China. In the Chinese political context, it is simply not practical for companies to focus only on maximizing profits delivered to shareholders. Large firms operating in strategic sectors, whether they be state-owned or private, must consider the government their most important stakeholder and stay on its good side.

Chinese companies are not free to maximize shareholder value, as they must also stay on the government's good side

Sometimes the price is low: for instance, making some donations in a poor province to support the government's poverty alleviation drive. Sometimes the price is higher. In 2017, for example, a consortium of companies including Alibaba, Tencent and Baidu invested RMB78bn into the Shanghai-listed unit of China Unicom, which had been chosen to pioneer "mixed ownership" reform of state enterprises (see **China Unicom's Mixed-Ownership Mixup**). Given how fast those internet companies are growing, giving the cash to a slow-growing state telecoms company instead of using it internally was certainly not the profit-maximizing decision. Yet it bought them goodwill with the state, and also helped fund the rollout of 5G mobile, which will be to their benefit. And both private companies and state enterprises are adept at benefiting from the panoply of government subsidies. Company management may often find it more important to stay on the government's good side than to please outside shareholders.

Macro trends and micro risks

Conditions are in place for Chinese equities to rally, but idiosyncratic risks for individual firms remain

For investors exploring opportunities in Chinese onshore equities, all these risks and idiosyncrasies need to be considered when screening for attractive investments. The Chinese stock market is still quite different from its global peers, and those differences will not melt away any time soon. At the moment, conditions are in place for Chinese onshore equities to deliver a solid rally over the next couple of quarters: US and Chinese trade negotiators are likely to get some sort of trade deal done, monetary policy will continue to ease at the margin and the profit cycle can turn upward as the auto and electronics sectors stabilize. Still, investors have to consider not just the direction of Chinese economic policy, but also how any individual firm is vulnerable to government intervention or regulatory change.