China: 6 reasons why

it poses a unique portfolio optimisation opportunity now

The second largest economy globally – China – is forecast to overtake the United States as the world's largest economy by 2030

Here is why a direct allocation to China A-shares via non-passive instruments gives investors greater access to a plethora of opportunities among small- and mid-cap companies.

Our analysis reveals that shifting 30% of one's global emerging market allocation to China A-shares could improve the overall portfolio return from an annualised 7.5% to 9.7%.*

1. Superior alpha-generating potential

The Chinese domestic equity market is on an evolutionary path – allocations from Western investors are increasing, driven by China's long-term economic growth prospects as well as the potential opportunities resulting from the inefficiencies seen in the country's domestic equity market.

2. Growing pool of opportunities

China's equity pool presents a significantly larger market cap than, for example, Europe. The A-share market alone encompasses more than 3,700 listed companies worth nearly $8.8 trillion across the entire market capitalisation spectrum). That's comparable to the $9.3 trillion market capitalisation of equities in the euro area[1].

3. Unique diversifier

The Chinese domestic market exhibits low correlation with other widely held asset classes (e.g. Hong Kong-listed H-shares and US and European equities) as shown in the table below, due to:

- being influenced by unique economic, political and monetary policy considerations. In fact, China A-shares companies yield 90% of their revenue domestically, in many cases leaving them well placed to avoid significant negative impacts associated with ongoing trade tensions with the US, and;
- very different market participants than elsewhere.

4. Opportunity in the 'new economy'

China is shifting from an export-driven economy into the so-called "new economy," characterised by an increased role for domestic consumption and higher-value-added sectors, such as: *tourism, entertainment, healthcare equipment, industrial automation, new energy vehicles, biotech, software and new materials.*

Investing in China A-shares provides greater access to the small- and mid-cap companies with the potential to be the future drivers for China's economic growth – *technology, innovation* and the rapidly expanding Chinese middle class. So, given that China is a major investor in, and adopter of, digital technologies, China A-shares better reflect the promise of the country's digital future than emerging market benchmarks such as the MSCI Emerging Markets Index, highly biased towards Chinese mega- and large-cap stocks.

5. The world is underweight China

The market cap of China A-shares as a percentage of global equities was 9% (end of 2019) and the overall Chinese economy accounted for 15.8% of global economic output in 2018[2].

With weighing of only 4.1% within the MSCI EM Index, focused on 'mega/large-cap', low-growth companies, and 0.5% within the MSCI ACWI Index, China A-shares are considerably under-represented in major indices.

6. Active expertise essential

In our view, not only is active management crucial in helping to exploit the inefficiencies of the market but experience is also essential in being able to identify the stocks that will improve longer-term portfolio performance and those to avoid. Downside protection is as critical as potential upside reward.

Because of domestic revenues and distinct economic and monetary policy, China A-shares have a low correlation with major equity markets

■ Low correlation ■ High correlation	China A-shares	HK-listed China stocks	Asia Pacific Ex-Japan equities	Global Emerging Markets equities	Japan equities	US equities	European equities	World equities
China A-shares	1.00	0.58	0.46	0.43	0.25	0.14	0.19	0.21
HK-listed China stocks	0.58	1.00	0.86	0.82	0.44	0.27	0.42	0.43
Asia Pacific Ex-Japan equities	0.46	0.86	1.00	0.93	0.54	0.32	0.51	0.55
Global Emerging Markets equities	0.43	0.82	0.93	1.00	0.46	0.47	0.63	0.68
Japan equities	0.25	0.44	0.54	0.46	1.00	0.15	0.29	0.34
US equities	0.14	0.27	0.32	0.47	0.15	1.00	0.62	0.92
European equities	0.19	0.42	0.51	0.63	0.29	0.62	1.00	0.79
World equities	0.21	0.43	0.55	0.68	0.34	0.92	0.79	1.00

As of 31 January 2020. Correlation data is calculated based on historical return of respective MSCI indices for the past 10 years, using weekly USD return. See full names of all specific benchmarks at the end of this paper. Source: Bloomberg, Allianz Global Investors

Allocation from global emerging markets (GEM) to China A-shares**

% shift out of existing GEM allocation	% Overall portfolio annualised return increase	
	From	To
10	7.5	8.3
30	7.5	9.7

% shift out of existing GEM allocation	% Sharp ratio increase	
	From	To
10	0.29	0.34
30	0.29	0.4

1 European Central Bank data, as of 31 December 2019
2 FactSet, MSCI, Goldman Sachs Investment Research, as of 31 December 2019
*Analysis of returns for the MSCI Emerging Market index (used as proxy for global emerging markets) and MSCI China A Onshore index (used as proxy for the China A-share market) indices from January 31, 2005 to January 31, 2020. Percentages represent portion of portfolio allocated to China A-shares. Past performance is not indicative of future results. Source: Allianz Global Investors.
**Table shows analysis of returns for the MSCI Emerging Market index (used as proxy for global emerging markets) and MSCI China A Onshore index (used as proxy for the China A-share market) indices from January 31, 2005 to January 31, 2020. Percentages shown in the table represent portion of portfolio allocated to China A-shares. Past performance is not indicative of future results. Source: Allianz Global Investors

Understanding the risk

Whilst offering significant opportunities, China A-share market carries risks:

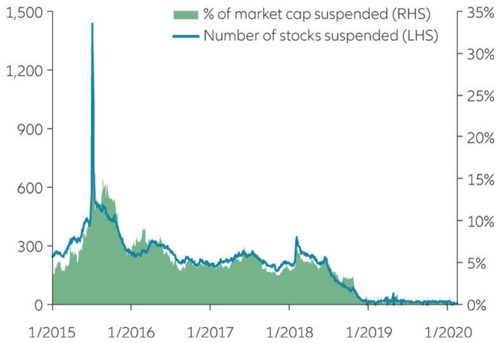
- it is inefficient i.e. dominated by domestic retail investors focused on chasing returns, contributing to higher volatility, which was something underlined in June 2018 when onshore China suffered declines of nearly 11%.
- stock turnover is more than double the typical stock turnover in the US resulting in a very high dispersion of returns.

Exacerbating risks, while the regulatory environment is evolving at a fast pace, China equity market remains fairly unpredictable.

In turn however, it provides opportunities for experienced active managers to add value.

China A-share stock suspensions have declined

% of China A-share stocks suspended



As of February 20, 2020
Source: Goldman Sachs, Allianz Global Investors

Allianz China A-Shares Strategy

For investors who want to tap into the China macro growth story, A-shares build a real picture of the Chinese economy, significantly broader and more diversified than that of Hong Kong-listed stocks. Our Allianz China A-Shares strategy allows investors to fully tap into this opportunity.

Allianz All China Equity Strategy

With Allianz All China Equity we select stocks from across the China equity universe including Shanghai, Shenzhen, Hong Kong and the US. Typically, around half of the portfolio is invested in China A-share stocks. This strategy can be appropriate for clients who see China as a standalone asset class and want a holistic approach to investing across all of China.

Allocating to China with Allianz Global Investors

Anthony Wong and Sunny Chung are the Portfolio Managers for both of the aforementioned strategies.

Anthony Wong, CFA, Portfolio Manager
14 years of investment industry experience

Sunny Chung, MBA, Portfolio Manager
Over 21 years of experience in investment-related roles

ACTIVE IS: SEIZING THE CHINA OPPORTUNITY

China – your active investment opportunity

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Value. Shared.

Investing involves risk.

Allianz Global Investors