Event summary: Experts eye index investing to tap China's equity potential

The case for global investors to boost their allocations to China equities is increasingly compelling.

Looking beyond the current macro and market headwinds dampening global economic growth, the country's transformation has a long way to go. By 2026, for example, China is expected to represent 25% of global real GDP growth, according to the IMF's World Economic Outlook in April 2022, up from around 16% today. Notably, technology-led innovation across the IT, healthcare and telecoms sectors will play an integral role in fuelling this momentum.

This all creates a big opportunity for investors. Yet there is a striking gap to fill; China makes up only 4% of the cap-weighted index despite its significant contribution to global GDP.

Further, the general under-allocation by overseas investors to China is clear from global and emerging market (EM) funds being underweight in Chinese stocks, compared with the MSCI ACWI Index and the MSCI EM Index.

To further understand these trends and explore how investors can capture China's strong investment potential via a passive route, IPE hosted a webinar on December 14th with three market experts from MSCI, Hong Kong Stock Exchange and E Fund Management, China's largest fund manager. They expanded on topics including the long-term value creation of China allocation, the growing adoption of index investing in China A share market and Hong Kong as an access point for global investors.

Investment demand for China

Global investors should be looking to access the domestic equity market in China with long-term value creation in mind.

Regardless of market performance in 2022, the performance of China's equity market varies by share type. For instance, explained Wei Xu, Executive Director of APAC Index Solutions Research at MSCI, "onshore China A-shares are more resilient to market downturns."

This is due to the onshore market being much larger, less concentrated and more diverse than the offshore market, he said. "The onshore market is more balanced and dynamic."

The low correlation of China A-shares to global markets should also appeal to global investors. "The correlation dropped to a level which was lower than the historical average in the past one year," noted Xu.

Another enticing aspect of China for global investors are the relatively high levels of return dispersion.

"China's market characteristics create alpha opportunities," he explained, adding that research shows the largest return dispersion occurred in the MSCI China A and MSCI China All Shares Indexes – close to the levels of the MSCI Emerging Markets Index and MSCI China Index.

Carving index routes to China

For those global investors with the appetite to widen and deepen access and portfolio exposure to China, index strategies offer an effective tool to shift the balance.

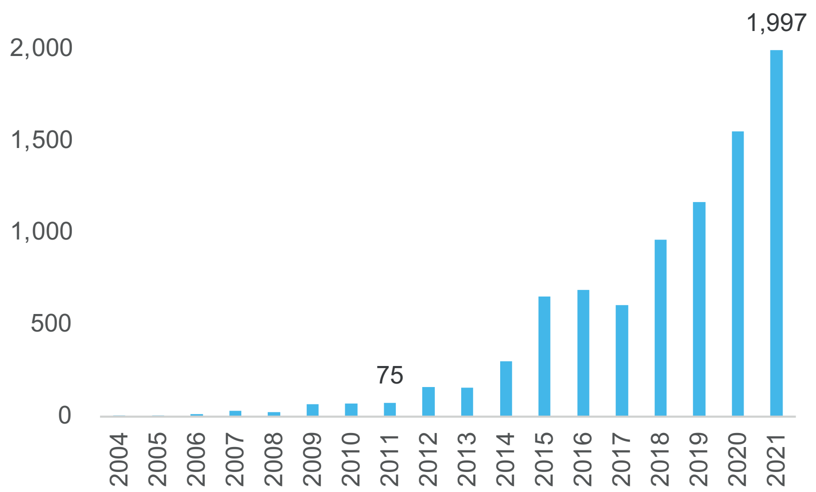
"There are a wide range of China-related indices offering a variety of risk/return profiles." said Wenkui Liu from Index Investment at E Fund Management. "These are an especially good option for those investors who are seeking low cost and transparent exposure to China."

It is notable that index investing enables asset owners to express their active views using both broad-based and thematic indices.

This is evident from the growing number of China-focused investors also using index investing to participate in the country's capital markets.

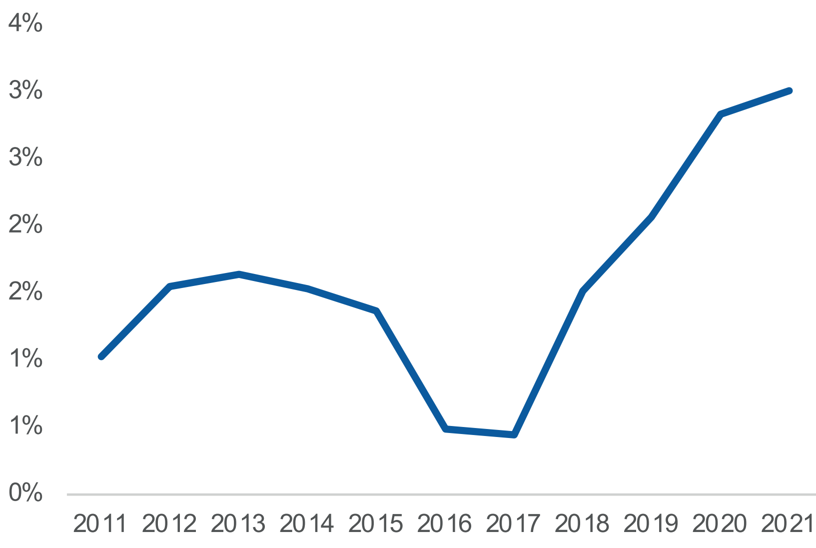
Among the various vehicles to achieve this, ETFs are increasing in popularity. China's onshore ETF market, for example, saw AUM reach RMB 2 trillion (USD 288 billion) by the end of 2021, based on an annualised growth rate of just under 40% in the past decade. Further, the fact that institutional holdings in ETFs soared by around 24% year-on-year in 2021 growth is even more proof that index strategies are viable as a way to tap into China's investment potential.

China ETF Market Size (in RMB Billions)



Source: Wind, as of 2004/1/1-2021/12/31

Total trade volume of Equity ETFs in China compared with A-Share market trade volume



Source: Wind, as of 2004/1/1-2021/12/31

"ETFs as well as other equity index strategies have caught the attention of portfolio managers as a low-cost way to increase their China equity exposure, while also providing diversification, liquidity and transparency," added Liu.

Reflecting these benefits, ETF trading volumes as a proportion of the total A-shares market have also soared – up from only 0.5% in 2017 to over 3% by 2021. By December 2022, this had risen even further, to more than 5%.

Hong Kong as an access point

As an access point for global investors into China via index strategies, Hong Kong is an increasingly popular route.

In particular, explained Brian Roberts, Managing Director, Co-head of Equities Product Development, Markets, HKEX, ETF trading in Stock Connect has been gaining momentum in recent months.

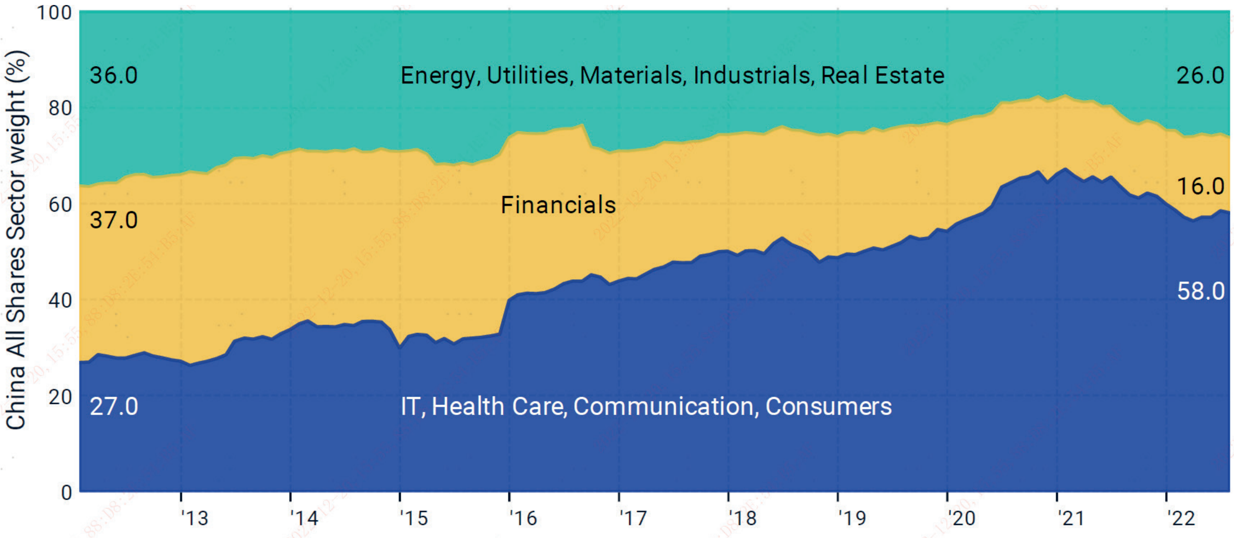
In terms of northbound ETF activity, he said the average daily turnover between July and November 2022 was RMB 56 million. Looking southbound, he explained, this figure was HKD 863 million (USD 111 million).

An alpha opportunity

Using the roadmap to China that index strategies can help navigate, investors cannot overlook the potential of China's thriving new economy.

Companies in industries such as IT, healthcare, telecoms and consumer goods, for instance, offer a relatively high-performance growth rate and return on equity, explained E Fund's Liu. "Their weight in the Chinese market has increased year on year, and is now almost 60%."

Evolving MSCI China All Shares Sector Weights



Source: Wei, Xu, Xu. MSCI, Foundations of Dedicated China Allocations: Part 2 - MSCI

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>
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Investors can also tap into the progress that China has made in its journey towards sustainability. Following the government's plan, announced in 2020, to reach carbon emission peaks by 2030 and carbon neutrality by 2060, a national carbon market launched in mid-2021.

"This has created beta opportunities in low-carbon industries," said Liu, "given the momentum in areas such as clean energy, energy storage and new energy vehicles."

Ultimately, with greater access and improved liquidity, overseas investors can readily adjust their exposure to China through index strategies. And as the domestic market continues to grow in scale and liquidity, as well as global significance, passive strategies should become a more important route for global investors to tap into China's investment potential.