Q2 2020

Crafting the Optimal China Allocation Strategy

The Asset Owner's Perspective

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2020 Sponsor's Statement

China is poised to become the world's biggest economy and is home to some of the world's largest equity and bond markets. Most investors, however, are underexposed to one of the principal engines of the world's economy at a time of slowing global growth and expectations for lower capital market returns in developed countries. The case for China as an investment destination is compelling, but a question remains: What is the most effective way to allocate to China? Traditionally, investors have accessed China through global emerging markets (GEM) and pan-Asian investment strategies. As China has become a larger portion of global indices over the past several years, some investors are taking a fresh approach with a dedicated China allocation to maximize diversification and potential alpha-generating benefits for their portfolios.

In partnership with Greenwich Associates, we were interested to explore China's role in global institutional portfolios and how China allocations are changing. We asked why relatively few institutional investors consider dedicated exposure to a market that has become too big to ignore in our view. At Matthews Asia, we have always embraced China as an investment destination and our years of experience have taught us not only to watch out for the potential pitfalls, but also to seize opportunities in its vast economy. We believe there is much that investors can do to optimize their China exposure.

Key Findings From the Research

This research study reveals several important trends: First, investors recognize that China has a strategic, long-term role to play in their portfolio. In line with institutional decision-making, the two primary drivers for investing in China are diversification (54%) and as a potential source of alpha (31%). Indeed, a majority of respondents reported that China is already part of their current asset allocation mix either through emerging markets or through a private equity allocation. In an unexpected twist, only one-half of respondents reported that they have fully implemented their investment plans for China—indicating that widespread asset allocation changes appear to be on the horizon.

Today, institutional investors are operating in the context of China's rapid stock market expansion, and inclusion of China's A-share market to global equity indices. This expansion has created more opportunities and more complexity for investors. Here, the research indicates that market access and risk management—especially concerns about corporate governance standards—are giving investors pause. Nearly 50% of investors in the study are holding back on dedicated China equity allocations primarily due to low trust in China's government, questions about market access, and negative perceptions of corporate governance policies. While caution is warranted, China has embarked on a program of reforms to make markets more investable, transparent and accessible—raising the bar for corporate disclosures and easing foreigners' access to its domestic stock markets. This disconnect between perception and reality creates opportunities for active investors.

Following the Leaders

Emerging from the research, we identified a core group of institutional investors and consultants who are at the forefront of this asset allocation trend. Inspired by the addition of China A-shares to MSCI indices as well as ongoing market reforms, this group considers themselves to be pioneers who are willing to test new approaches to investing in China's equity and fixed-income markets. That attitude also is reflected in the fact that 23% of respondents plan to increase or significantly increase their dedicated allocation to China's equity markets in the next three to five years. When speaking about how their organization reacted to A-share inclusion in MCSI indices, one U.S. plan sponsor confirmed, "[We're] looking at regional managers to increase our China exposure." Similarly, an Australian consultant noted, "I think [A-shares inclusion in MSCI indices] has heightened awareness of the importance of investing in China going forward."

We at Matthews Asia aspire to partner with you to make the most of the China opportunity. Based on nearly 30 years of experience investing in China, we have compiled key resources for institutional investors who want to learn more about market access and corporate governance as well as about the practical considerations of investing in China's A-share market. We invite you to contact us to learn more.

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ASSET OWNERS EXPECT TO ALLOCATE MORE TOWARD EM ASSET CLASSES IN THE NEXT 3-5 YEARS, INCLUDING DEDICATED CHINA ALLOCATIONS

ONLY 54% OF ASSET OWNERS FEEL THAT THEY HAVE FULLY IMPLEMENTED THEIR CHINA INVESTMENT PLAN

Executive Summary

Many pension funds, endowments, foundations, and other institutional investors have hesitated about making direct investments in China due to uncertainty about political risks, concerns about governance standards, and, until recently, limited market access. However, as projections suggest that China may soon emerge as the world's biggest national economy, many asset owners and investment consultants have begun to reassess the optimal level of China exposure in their portfolios and how to best achieve this objective.

Because most asset owners today obtain China exposure through investments in global and/or emerging markets products, many of these investors believe—or at least believed—that they have sufficient allocations to the country. However, the indirect nature of these allocations makes it difficult to quantify and manage that exposure. In fact, a large number of asset owners say they don't have a clear understanding of their own exposure to one of the world's most important nations. Among those that do, there is a growing awareness that current exposure levels achieved mostly indirectly through allocations to global and emerging markets strategies are inadequate.

Recognizing this fact, some institutions have begun to consider moving beyond their current approach and start making direct investments in China. Their investment consultants agree: Nearly 40% of consultants doubt that EM managers are effectively allocating to China, suggesting that a new approach is in order.

As asset owners consider ramping up the level of direct investment, they are being forced to confront one of the main factors that caused them to hesitate in the past: China's opaque corporate governance standards that can make it difficult to assess the performance of companies across both financial and increasingly important ESG metrics. (Twenty-one percent of asset owners see the potentially positive ESG impact as a reason to invest in China.)

To overcome this obstacle, and to educate their committees and boards about myriad other perceived risks present in this rapidly developing market, many asset owners are turning to experienced asset managers. Managers with specific expertise regarding the China market (specifically with an on-the-ground presence), combined with factors such as risk management capabilities and an investment team with long-term success investing in China, can alleviate these concerns, articulate how to appropriately consider and manage the risks and highlight potential benefits of the direct investment approach.

METHODOLOGY

During Q3 & Q4 of 2019, Greenwich Associates interviewed 118 institutional investors globally, including public and private pension plans, endowments and foundations, insurance companies, sovereign wealth funds, and 20 investment consultants. Respondents were asked about their goals and objectives with respect to portfolio allocations to China, including their current investment levels, as well as the key factors for either increasing their allocations or not allocating to a dedicated China manager. Other topics included the manager selection process, satisfaction with current managers and expected allocation shifts across asset classes.

Introduction

Recent research conducted by Greenwich Associates and Matthews Asia reveals that nearly 50% of asset owners feel that they have not fully implemented their investment plan with regard to allocating to China. Even more eye-opening is the fact that nearly one-third of the investors say they don't have a clear understanding of their own portfolio exposures to one of the world's most important economies. A likely explanation: the majority of institutional investors achieve most of their China exposure through emerging markets strategies that allocate a share of their overall assets to the country rather than via dedicated China investments. Almost 70% of investors in the study say EM equity strategies are their primary—and in some cases only—source of China exposure.

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Of the 62% of study respondents who were confident they could quantify their fund's exposure to China, the average exposure was only 4.6% of total assets (inclusive of global and EM strategies' exposure to China). Further, the data show significant regional differences, with global averages inflated by Asian investors (10.4%). Allocations among North American institutions average just 4.5% of total assets, while European institutions have an even lower level of exposure to China (only 1.9%). Globally, pension funds have shown less willingness to maintain a China exposure, with just 3.3% of their total assets either directly or indirectly exposed to China, compared to endowments and foundations with 5.0%.

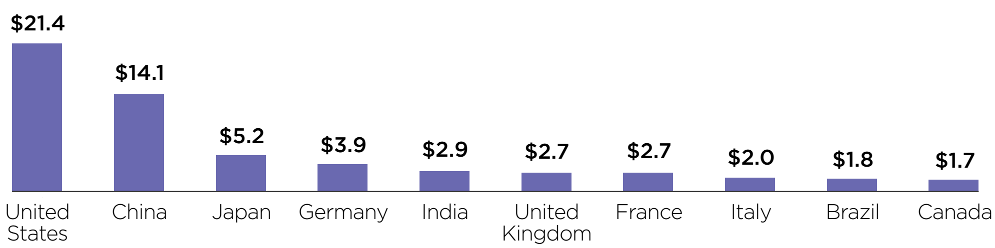
Quantifying Underweight China Allocations

To place these allocations in context, China's GDP is just over $14 trillion, second only to the United States with $21.4 trillion in GDP. China also ranks second behind the United States in terms of global equity market capitalization. China-listed domestic companies have a total market cap of $6.3 trillion, while the U.S. market cap is over $30 trillion. The story is much the same in terms of debt securities, where $12.9 trillion of Chinese public and corporate debt is outstanding, second only to the United States at $41.3 trillion. While a direct correlation between a risk-neutral weighting of global GDPs and institutional portfolio allocations is uncommon and unlikely, recent changes in the Chinese market invite an opportunity for allocators to reconsider exposure levels, bringing their portfolio more in line with relative market-sizing measures.

Only 14% of asset owners globally—and just 5% of North American institutions—have any dedicated exposure to China's equity markets.

SHARE OF GLOBAL GDP—2019

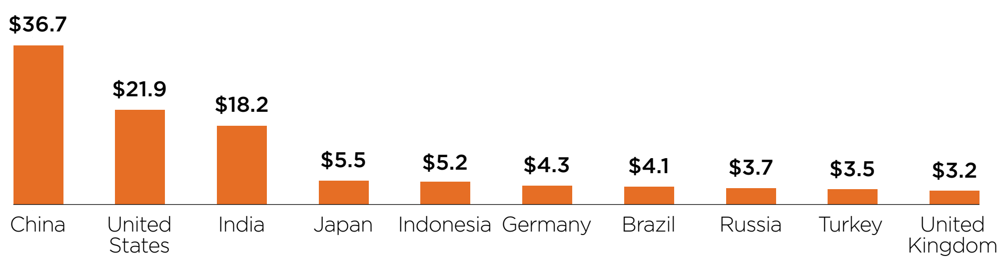
USD trillion



Source: International Monetary Fund (IMF), Organisation for Economic Cooperation and Development (OECD)

PROJECTED SHARE OF GLOBAL GDP—2030

USD trillion



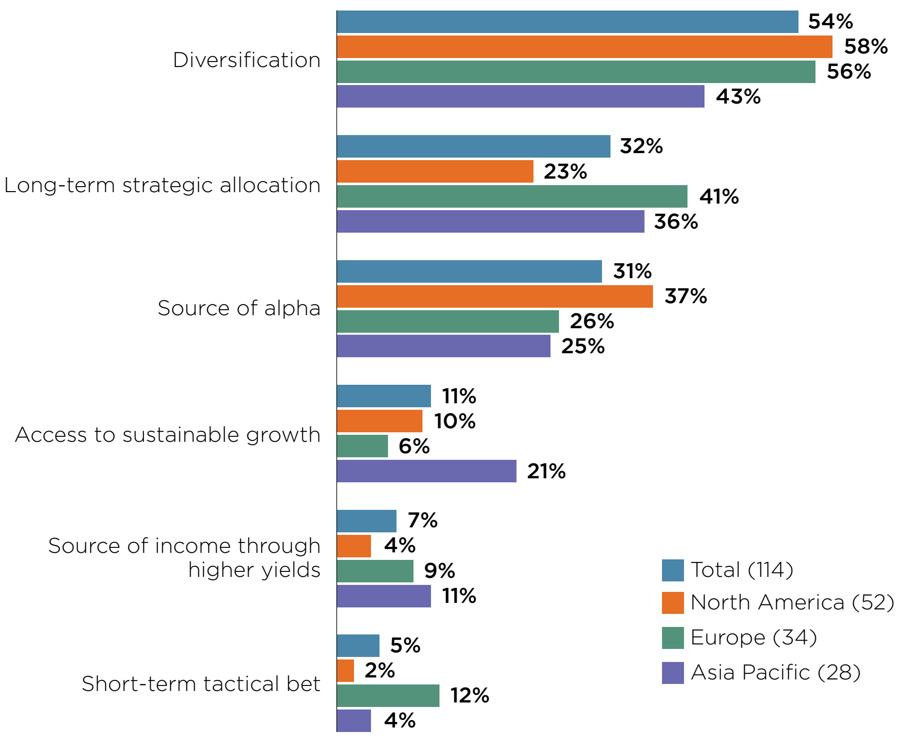
Source: International Monetary Fund (IMF), Organisation for Economic Cooperation and Development (OECD)

Only 14% of asset owners globally—and just 5% of North American institutions—have any dedicated exposure to China's equity markets. While limited market access in the past dictated such a small proportion of investors to invest directly, much progress has been made in opening Chinese markets to foreign investors. The Chinese equity markets have become more accessible through the launch of the Hong Kong-Shanghai/Shenzhen Connect and the planned removal of the QFII quotas, which limited foreign investment in China A-Shares. On the fixed-income side, the introduction of BondConnect now allows foreign investors access to the on-shore bond market through established trading venues such as Tradeweb and Bloomberg.

Why China?

When it comes to investments in China, asset owners cite three primary roles within their portfolio: diversification, long-term, strategic beta exposure, and alpha generation. These goals make sense in the context of institutions needing to realign portfolios to reflect China's growth. China's economy and the outlook of its capital markets present a unique opportunity for asset owners, which could help alleviate regional concentration concerns, especially in developed markets facing their own political uncertainty. Indeed, when asked to name the factors driving interest in China, institutions cite China's growing market size, expanding contribution to global GDP and the ongoing index inclusion process as their top three responses. Also on that list of drivers is improved market access, the potential to generate alpha and an ability to exploit a now more favorable macro view of China.

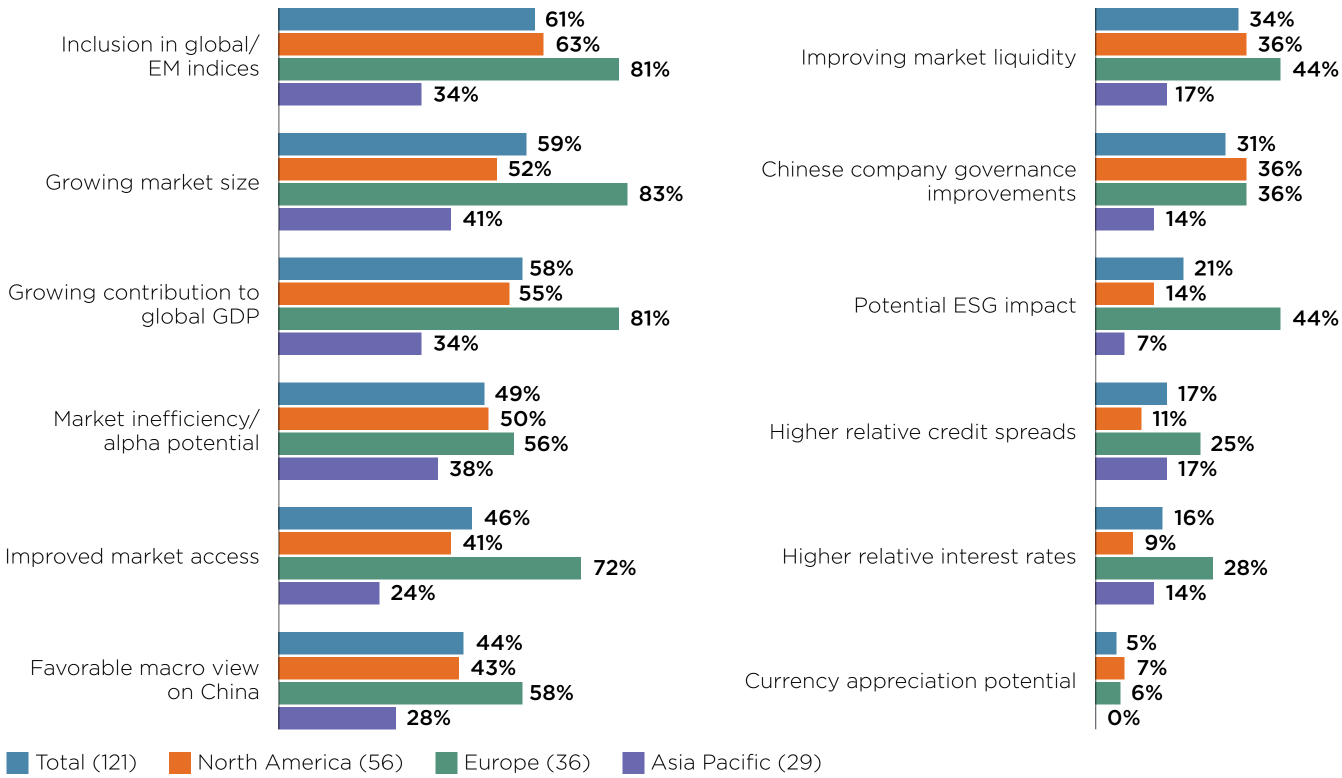
THE ROLE OF CHINA IN INSTITUTIONAL INVESTORS PORTFOLIOS



Note: Based on 114 respondents.
Source: Greenwich Associates 2019 Investing in China Study

Institutions realize there is work to be done in their portfolios to achieve these goals. In fact, about half the institutions in the study say they have not yet implemented their full, China-specific investment plan. Institutions within Asia are, surprisingly, the least likely to say they have fully implemented a plan. Given the impact that Chinese economic trends have on their own national and regional economies and markets, a greater proportion of Asian firms (relative to the global average) are actively considering hiring a China-specific manager as a way to build out their comprehensive China investment plan. The situation in Europe is more puzzling, as 62% of European institutions report that they have fully implemented a China investment plan, despite the fact that average China allocations among institutions in Europe are the lowest in the study, at just 1.94% of total assets.

REASONS FOR INVESTING IN CHINA



Note: Numbers in parentheses represent number of respondents.
Source: Greenwich Associates 2019 Investing in China Study

No Shortage of Risks and Concerns

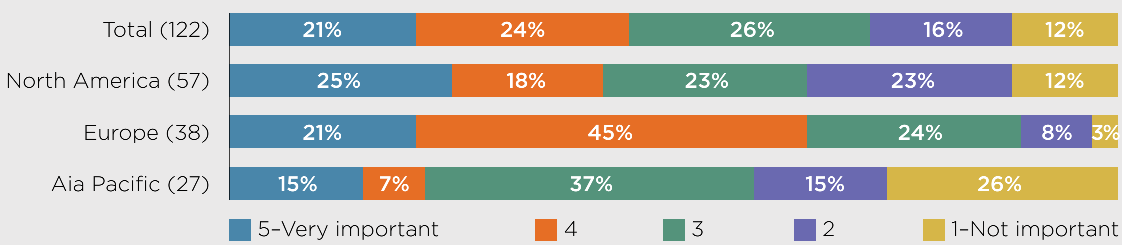
When it comes to implementing dedicated China strategies, institutions say several prominent concerns have caused them to move slowly. At the top of that list are three factors: 1) A basic lack of trust in the Chinese government, 2) geopolitical risks and 3) corporate governance standards perceived as being sub-par.

As a California pension fund explains, “We made a conscious decision to not go in there in a big way, and we will decide if that will change depending on changes to the governance and legal structure in China.” Not all investors are in agreement with regard to the lack of corporate governance in China, however. One Australian investment consultant finds concerns are not ubiquitous: “Some clients have a more aggressive tolerance for risk and perhaps have the fund characteristics that mean that they can tolerate more volatility with regard to its investments. Those that are invested in a dedicated China private equity or venture capital strategy as a subset of their portfolio are more progressed and have quite mature programs and understandings of the governance controls in place.”

ESG—WITH A STRONG EMPHASIS ON THE “G”

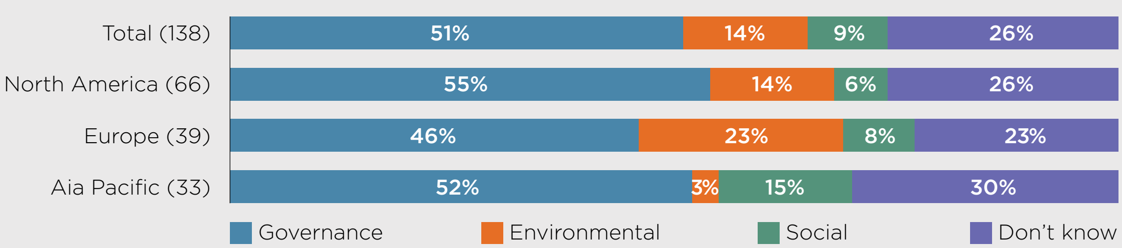
Environmental, social and governance issues are having a real impact on institutional decision-making when it comes to investments in China. That’s especially the case in Europe, where two-thirds of institutions in the study rank ESG factors as important or very important with regard to China allocations. Within this category of concerns, governance ranks by far the most important. More than half the investors in the study cite governance as a critical factor in evaluating Chinese investments—a share that climbs to 55% among institutions in North America.

IMPORTANCE OF ESG INTEGRATION REGARDING ALLOCATIONS TO CHINA



Note: Numbers in parentheses represent number of respondents. May not total 100% due to rounding.
Source: Greenwich Associates 2019 Investing in China Study

MOST IMPORTANT ESG FACTOR WHEN CONSIDERING CHINA



Note: Numbers in parentheses represent number of respondents. May not total 100% due to rounding.
Source: Greenwich Associates 2019 Investing in China Study

About half the institutions in the study overall and nearly 70% in Europe cite a lack of access to Chinese markets as a roadblock to investment. But this perception appears not to reflect reality. China has implemented programs to give foreign investors wider market access, including StockConnect and BondConnect, as well as the planned removal of QFII and RQFII quotas. One would expect that as foreign investors continue to invest money in China, transparency will be rewarded in the equity markets, as active managers will be allocating to those companies that meet global governance standards. Many of the other concerns cited by institutions relate to cyclical and macro risk factors associated with the Chinese market—including market volatility and currency risk.

These concerns have thus far caused institutions to move at a very deliberate pace. Although overall allocations are projected to rise in the next three to five years, the share of institutions with plans in place to significantly expand their own allocations to China remains relatively small. Encouragingly, many institutions, in North America especially, are expecting to allocate significantly more to emerging markets at the expense of their developed market allocations.

This increased confidence in EM will certainly increase overall exposures to China. As more funds flow into EM, allocators will inevitably take a closer look at investment opportunities in China, especially as it makes up a larger proportion of EM indices. Not surprisingly, the most bullish investors in those terms are found in Asia, where 30% of institutions are planning to significantly increase allocations to dedicated China equities. The shares remain more modest in other regions, with 17% of North American institutions and 14% of European institutions saying they have active plans to increase or significantly increase allocations in that timeframe.

In addition, investment consultants are optimistic that dedicated allocations to China will grow. One U.K. investment consultant mentioned that client interest in China has grown since its inclusion in many EM indices. "There has been significant interest in terms of number of questions and queries—asking for educational confirmation—with a small number making a separate allocation. We would expect this to grow over time." Not only have clients had more interest in learning more about China, several investment consultants believe that EM generalists are not efficiently allocating to China. "I believe that the Chinese-direct or specialist Chinese managers have an edge."

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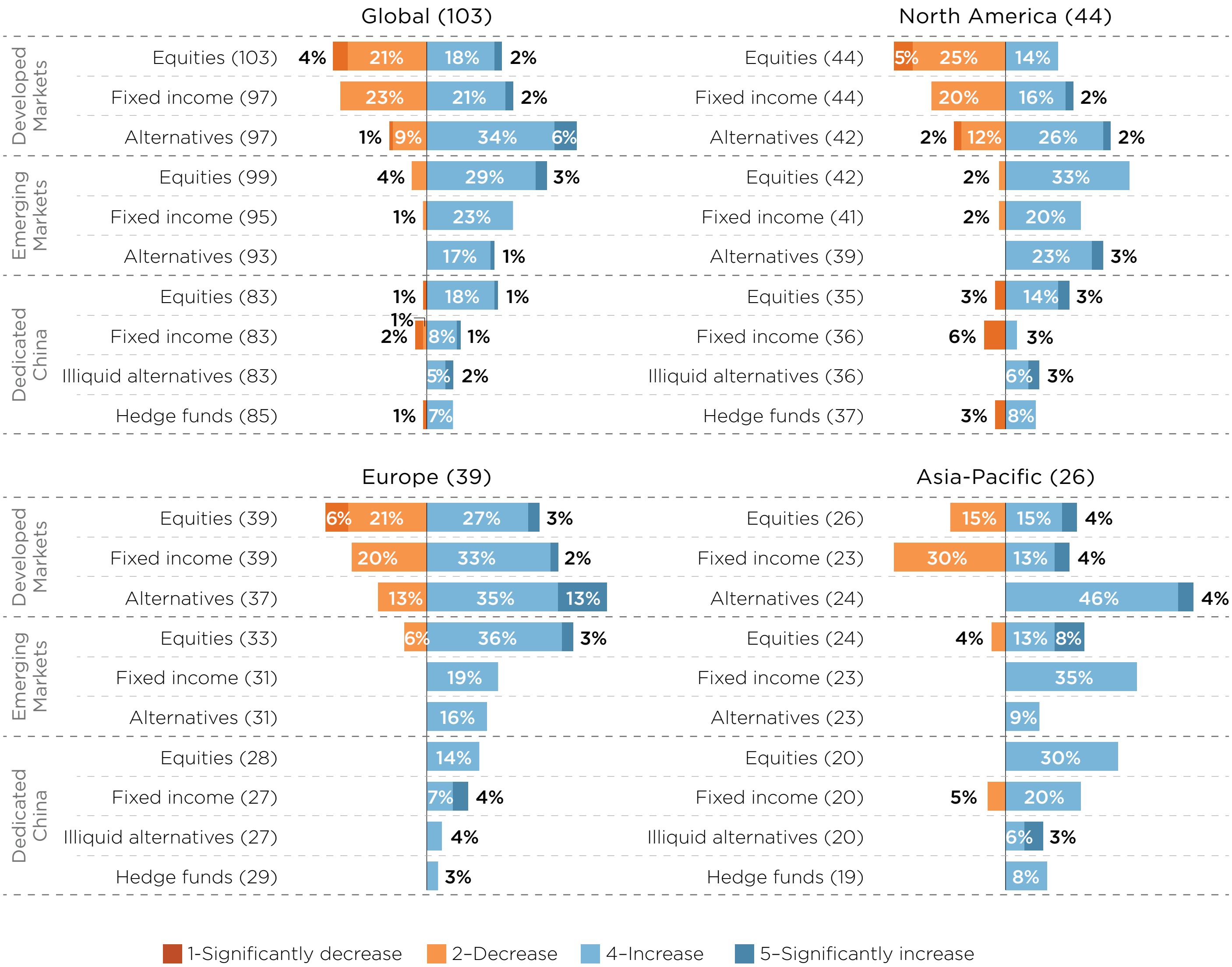
EXPECTATIONS OF CLIENTS' ALLOCATIONS IN NEXT 3–5 YEARS



Note: Numbers in parentheses represent number of respondents.
Source: Greenwich Associates 2019 Investing in China Study

[1] https://www.msci.com/msci-china-a-inclusion

Emerging Markets Funds Don't Deliver Sufficient Exposures

Despite some headwinds, exposure to China in institutional portfolios has been increasing over the past few years. One of the main drivers of increases within the past year has been the integration of China "A-shares" into the MSCI Emerging Markets Index and other popular EM indexes. In 2019, this "inclusion" process increased the weighting of A-shares—stocks that trade in mainland China on domestic exchanges—to 3.3% of the MSCI EM Index from just 0.7%. That move, which helped increase the overall China weighting of the index to about 31%, represents just phase one of the MSCI inclusion process, which will integrate more China A-shares into the EM Index over time. In the event of full inclusion, MSCI estimates China equities would exceed 42% of the index.[1]

Although A-share inclusion in popular benchmarks forced Global EM funds to increase their China exposure, it's important to note that EM strategies make up only about 11% of total institutional assets. That includes 6% of allocations to EM equities, 4% to EM debt and about 1% to alternative EM strategies. At those levels, even with 40% China weightings, EM strategies will provide far too little exposure to reflect China's actual contribution to the global economy today and for the foreseeable future.

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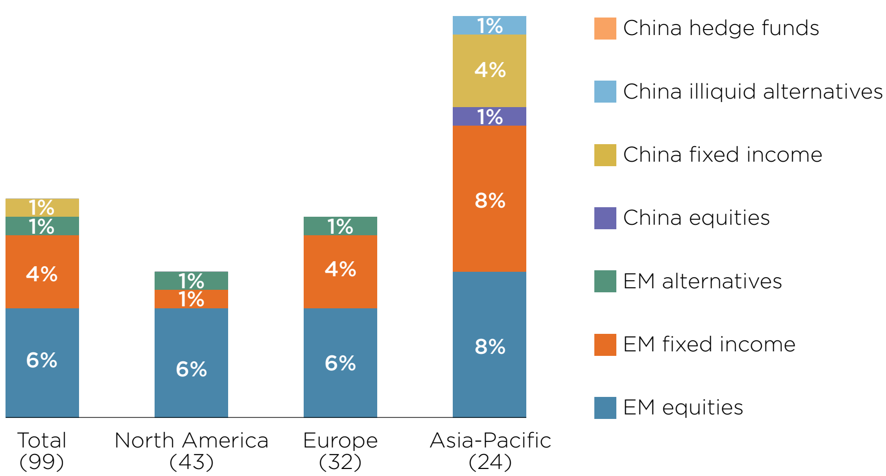
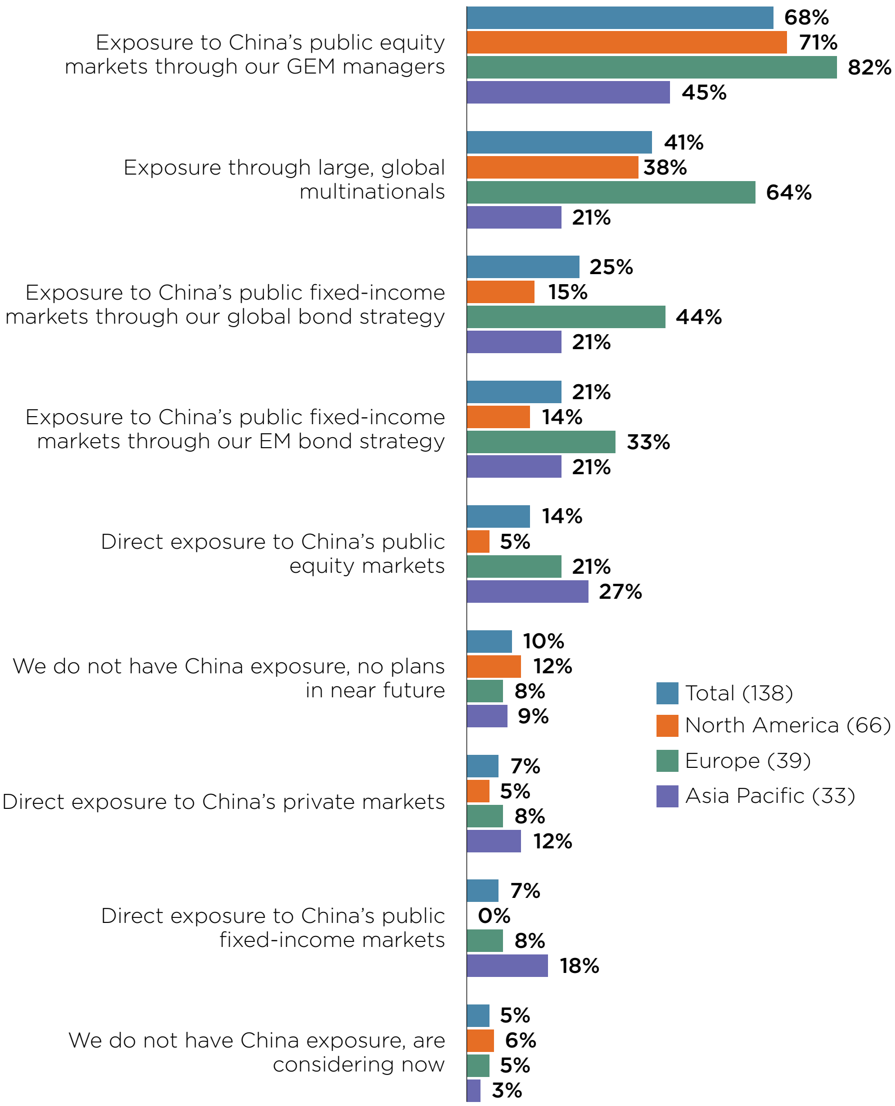
PROPORTION OF TOTAL ASSETS ALLOCATED TO EMERGING MARKETS



Note: Numbers in parentheses represent number of respondents. May not total 100% due to rounding.
Source: Greenwich Associates 2019 Investing in China Study

Beyond the minority of allocators investing in China on a dedicated basis, institutions do achieve some additional China exposure elsewhere. About 40% of respondents say they add to their China exposure through investments in large, global multinationals with business and/or operations in the country. A quarter of investors also access China through global bond strategies, and about 1 in 5 do so through EM bond strategies.

CURRENT EXPOSURE TO CHINA



Note: Based on 138 respondents.
Source: Greenwich Associates 2019 Investing in China Study

For now, institutional investors broadly report satisfaction with their emerging markets managers' ability to allocate effectively to China. As a representative of a U.K. pension fund explains, "We have external fund managers who will hold Chinese assets as they see fit and proper, and we are comfortable with that." In the short term, it looks like this trend will continue as well. Asset owners expect inflows into EM assets to increase nearly 10 times their expected outflows. For Chinese assets, expected net inflows are only roughly three times expected outflows. Meanwhile, developed market asset classes are not expected to see an increase in net flows over the next three years.

Interestingly, the investment consultants upon whom these asset owners often rely heavily for advice are more skeptical. Nearly 40% of investment consultants participating in the study express some doubt that global emerging market managers are effectively allocating to China. As part of an emerging markets strategy, China is unlikely to receive as much dedicated focus and in-depth research as could be done by a team running a China-direct strategy.

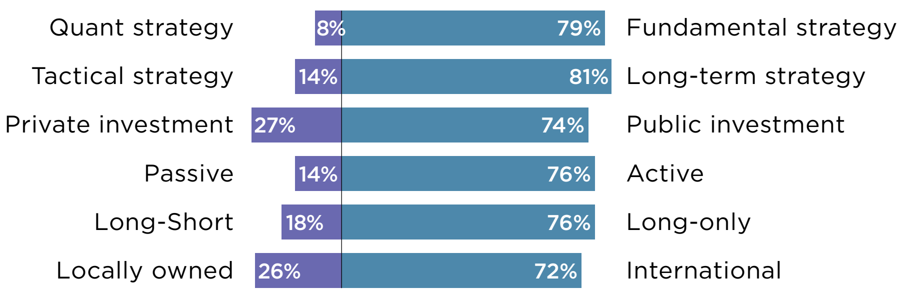
Some institutions have already broken off from the pack when it comes to allocating directly to China. Of the institutions with an AUM over $25 billion, one-third invest directly in China's private markets, often allocating to private equity and/or real estate. The size of the institution is not the only common characteristic found among investors allocating directly to China. Asset owners that cite their organizations are willing to be a pioneer and investigate emerging asset classes/products are twice as likely to have a direct allocation to China. Further, firms that are directly invested in China are three times less likely than their peers to be wholly dependent on external advice. Lastly, despite a small sample size in our population, asset owners in Sweden are the most likely to invest directly in China, with 60% allocating directly.

The Ideal Dedicated China Strategy

Despite limited action to date, institutions in the study have clear preferences when it comes to dedicated, stand-alone investment strategies for China. The ideal approach will be actively managed, fundamentally driven (as opposed to quantitative), long-term in nature, and focused on public investments.

With these parameters in mind, how will institutions go about navigating these obstacles and expanding China allocations to more appropriate levels? To start, investors should consider hiring managers with the resources, experience and skills required to manage (and adequately explain) the inherent risks and opportunities.

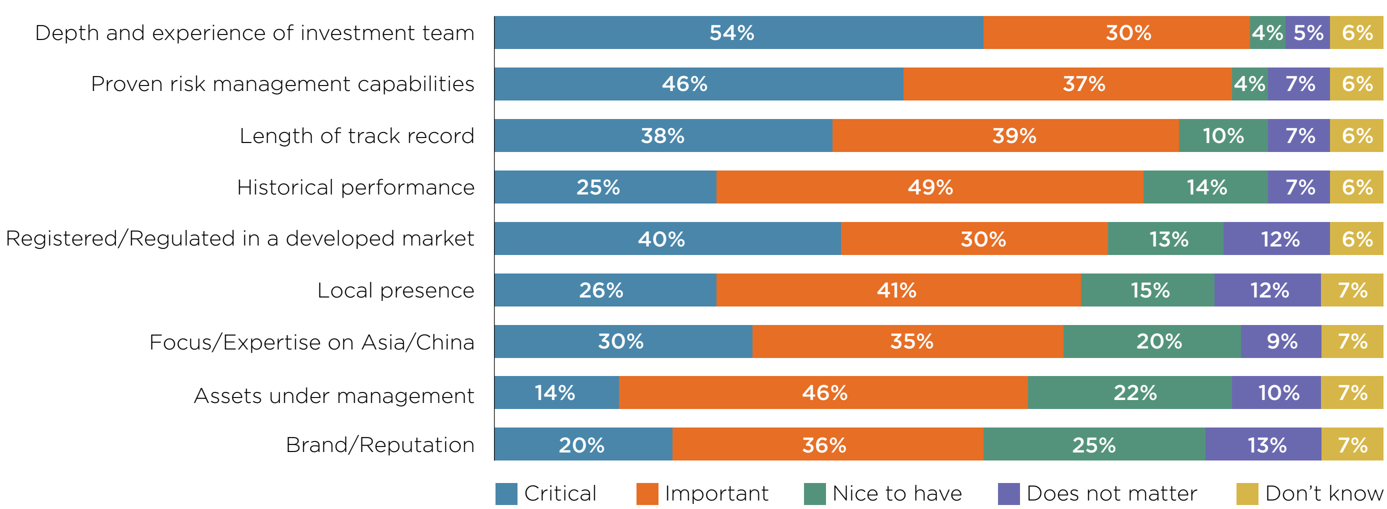
OPTIMAL CHINA INVESTMENT APPROACH



Note: Based on 121 respondents.
Source: Greenwich Associates 2019 Investing in China Study

Investment professionals at pensions, endowments and foundations, and insurance companies would prefer to work with managers that are long-only in approach (as opposed to long-short) and international in scope (as opposed to local to Asia). Among that group, institutions will gravitate toward managers whose investment teams have deep expertise in China attained through many years of experience in the country. That expertise will be demonstrated by factors like a long track record, solid and extensive historical performance and a specific focus on China and/or Asia. Proven risk-management capabilities will also be a key driver within institutions' manager selection frameworks. Finally, many investors will be looking for managers with a local presence demonstrated by on-the-ground operations and local registration/regulation.

MOST IMPORTANT ATTRIBUTES FOR A CHINA MANAGER



Note: Based on 138 respondents. May not total 100% due to rounding.
Source: Greenwich Associates 2019 Investing in China Study

ARE "BOOTS ON THE GROUND" MANDATORY?

Is it a necessary requirement for China managers to have "boots on the ground" in the country? On that question, study respondents are divided; investors broadly say "yes" but consultants are less concerned.

Thirty-seven percent of pension funds and 40% of endowments and foundations say they would consider hiring a manager without operations within China for dedicated China investments.

"If we look at other markets where we operate, we have managers without a local presence. While some of the managers we use employ local experts, track record and historical record are more important to us," says a respondent from a U.K. pension fund. Another U.S. pension fund professional disagrees: "I think because of governance and political risks, local knowledge is critical to avoid potential landmines."

Many investment consultants disagree. Three-quarters of the consultants in the study say they would consider recommending a manager without a local presence. "If they have the track record and right sort of strategy, I don't think it is necessarily critical they have a base in China," says one consultant. Another consultant agrees: "If a manager is located in Hong Kong and can travel to the region quite readily, I view that as fine, as long as they have the right people in their organization that have the right contacts. So it is important but not necessary."

Conclusion

Institutional asset owners have been somewhat hesitant to take on direct investment exposure to China. Wary of trade tensions, geopolitical issues and more general concerns about the country and its government, most asset owners have been content with the relatively minimal China exposures provided through investments in global emerging market funds.

It is critical, however, to identify the dichotomy between perception and reality when it comes to some of these concerns. Market access has dramatically improved and will continue to do so with additional expected changes on the horizon. In addition, corporate governance standards and transparency have continued to improve supported by state-led reforms in an effort to attract foreign capital and to better align company interest with that of minority shareholders. Despite significant improvements in those areas, an expert review of the risks and opportunities on the ground is key to providing sustainable returns.

Staying on the sidelines with respect to China will become increasingly untenable given the trajectory of China's growth as a driver of financial markets and global GDP. In fact, many institutions that find themselves on the forefront of innovation and identify as pioneers have already created a dedicated, direct allocation to China and plan to increase these allocations over the next few years.

To create portfolios that are properly weighted and appropriately diversified, many asset owners will need to significantly expand allocations to China. Perhaps the most obvious and impactful way to achieve that goal is to hire an active, proven investment manager with the experience, expertise and capabilities required to manage the many risks and opportunities associated with Chinese investments.

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