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INVEST WITH CONFIDENCE

China Unexplored

Going beyond the obvious to find tomorrow's winners

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Why there's more to China than just big tech

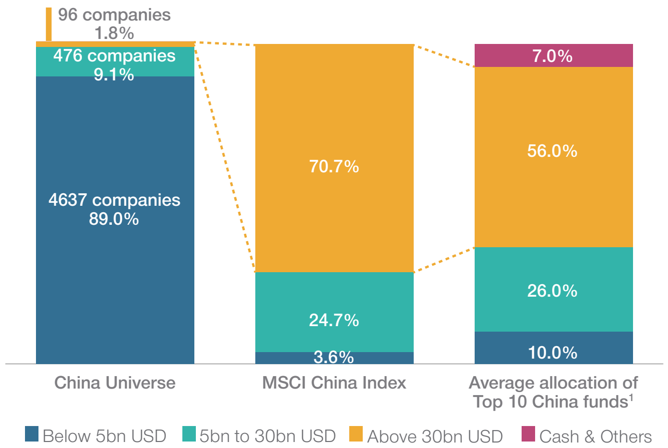
The growth and sheer dynamism of the Chinese economy and its stock market continue to offer the potential for [attractive returns for active investors in Chinese equities](). The question, therefore, becomes one of how to approach investing in China. There are a handful of huge companies which have come to dominate China and emerging market equity indices. As a result, most investors holdings in Chinese equities – be it via China, Asia or emerging market funds – tend to be concentrated in a small number of well-known companies that have already achieved 'mega-cap' status.

Allocation skewed towards mega-caps

Currently there are 730 Chinese companies listed in the MSCI China Index (as at 31 July 2021) – yet the investable universe comprises more than 5,500 listed stocks. In short, the index is not an accurate representation of the opportunity set. With such a large investment universe it is perhaps surprising then to note that the largest 100 stocks, by market cap, account for a staggering 71% of the MSCI China Index.

This underrepresentation is important, not only because of the broad range of investable opportunities A-shares have to offer, but also because the A-share market remains highly inefficient given its retail-driven investor base. It is a high liquid, high velocity market, with local retail investors accounting for over 80% of market turnover and an average holding period of just 17 days (source: Goldman Sachs Global Investment Research).

Fig. 1: Market cap breakdown by stock count



As at 31 December 2020

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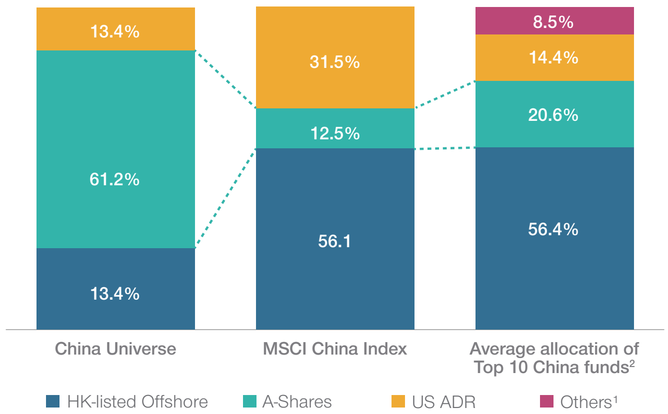
Please see Additional Disclosures page for information about this MSCI and Morningstar information.

[1] The Top 10 China funds refer to the funds in the Morningstar China Equity universe, measured by AUM.

Furthermore, a lack of sell-side coverage outside of a handful of A-share companies serves only to exacerbate these inefficiencies and creates mispricing opportunities. Coverage of A-share companies with a sizeable market capitalisation of between US$5-US$30 billion are covered, on average, by five analysts. For companies with a market cap below US$5 billion, the average falls to just one. As such, we believe the A-share market presents an attractive opportunity set for skilled fundamental, active investors to invest in potentially mispriced assets (source: Financial data and analytics provider FactSet. Copyright 2021 FactSet. All Rights Reserved).

That said, it's not just about A-shares either. We encourage investors to take a truly holistic approach to the China universe to be able to identify the best opportunities across the entire on-shore/off-shore universe thereby maximising both diversification and alpha generation.

Fig. 2: China universe share type breakdown (US$11.4 trn)



As at 31 December 2020

Sources: MSCI, Goldman Sachs, Morningstar. Please see Additional Disclosures page for information about this MSCI and Morningstar information.

[1] Top 10 AUM fund holdings outside of China Universe, non-China stocks, derivatives and cash.

[2] The Top 10 China funds refer to the funds in the Morningstar China Equity universe, measured by AUM.

Capital market reforms have expanded the investable universe

A decade ago, the ability to invest in local markets for foreign investors was still highly restrictive, with access via a largely complex and limited quota system, referred to as QF-II. In recent years, however, reforms led by the Chinese government aimed at opening up their markets to overseas capital, resulted in the launch of the Stock Connect program in 2014. This facility connects the onshore (Shanghai) and offshore (Hong Kong) stock markets, enabling foreign investors to access local shares and local Chinese investors access to offshore markets. This instantly expanded the investable universe for foreign investors and the correlation of the China A-shares market with global indices has increased markedly since 2015 as a result. This rise in correlation means it has become more important for investors seeking diversification to explore less crowded opportunities outside of the well-owned mega-caps.

The scale of the opportunity and the ability today to invest across both onshore and offshore markets provides global investors with the potential to invest in future winners today before they reach mega-cap status. And yet, investors who are led by mainstream indices in the size and make-up of their China equity allocation could be missing out. Chinese equities are both under-represented and under-explored in most investors' portfolios, with many exposed merely to a handful of the largest and most owned companies. Indeed, for the majority, they will likely already have exposure to these names through existing global emerging or Asia portfolios. While many of these mega-caps will have rewarded investors and remain sound companies, it is the overlooked and highly inefficient part of the market outside of that narrow subset that, in our view, warrants a deeper look and presents attractive potential for outsized alpha generation. As such, we believe it presents an abundant opportunity for the curious investor willing to go beyond the obvious.

Fig. 3: A summary of the main China share types available

Type	Listing	Available to foreign investors	Active companies	Share class market cap (in billions USD)	Description
A-shares	Onshore	Yes (see description)	4,321	12,635	Securities of Chinese incorporated companies that trade on either the Shanghai or Shenzhen stock exchanges. They are traded in Renminbi (Chinese Yuan), and can only be traded by residents of the People's Republic of China or under the Qualified Foreign Institutional Investor (QFII), the Renminbi Qualified Foreign Institutional Investor (RQFII) rules, or via the Northbound Stock Connect programs.
B-shares	Onshore	Yes	91	19	Chinese incorporated companies that trade on either the Shanghai (in US dollars) or Shenzhen (in Hong Kong dollars) stock exchanges.
H-shares	Offshore	Yes	285	831	Companies incorporated in mainland China with listings in Hong Kong and approved by the China Securities Regulatory Commission (CSRC).
Red chips	Offshore	Yes	166	581	Companies incorporated outside of mainland China (mainly in Hong Kong) and controlled by mainland Government entities.
P-chips	Offshore	Yes	662	1,754	Companies that are incorporated outside of China but listed in Hong Kong are referred to as P-chips or Hong Kong-listed Chinese private companies.
N-shares	Offshore	Yes	212	1,330	Companies incorporated outside the People's Republic of China and traded on the New York Stock Exchange, the NASDAQ exchange, or the NYSE American with a majority of their revenue or assets derived from mainland China.
S-chips	Offshore	Yes	48	23	Companies incorporated outside the People's Republic of China and traded on the Singapore Stock Exchange with a majority of their revenue or assets derived from mainland China.

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