Weighing up China: accessing the world's growth driver

The allure of China's vast economy and expanding universe of securities looks set to draw increasing attention from investors around the world.

Adding to the appeal from the size and diversity of the domestic market, recent factors have made it even more compelling: the rebound since the pandemic; further reforms to make onshore stocks and bonds more accessible; and renewed government commitment to encouraging sustainable growth.

Such dynamics bring with them much-needed potential for China to play a larger role in global equities and fixed income portfolios via more dedicated allocations.

The trajectory of flows from European-domiciled investment funds, for example, is encouraging as a step towards this. The region now accounts for an increasing proportion of inward investment into China, rising from 33.1% at end-2017 to 56.2% by the end of last year, according to a study conducted jointly by Luxembourg for Finance and PwC.

This trend reflects the path of some of Europe's largest pension investors. Netherlands-based APG, for instance, forged a partnership with E Fund Management in 2016 that led to the launch of a China A-Shares strategy in September 2017, which has returned 10-12 percentage points above benchmark on an annualised basis since inception.

Increasingly, like-minded institutional investors are able to explore the option of investing in similar strategies.

Investing in China's new future

More broadly, global pension investors can expect an ever-wider opportunity-set as a result of China's 14th Five-year Plan, revealed in the first quarter of 2021.

"The focus will be on the quality of economic development, and sustainability will become objective criteria for measuring future economic development, while no quantitative GDP growth target was set," said Sau Kwan, President of E Fund Management (E Fund), China's largest fund manager with over RMB2.49trn ($385bn) in AUM as of June 30th 2021.

The coming years will likely see far-reaching innovation – to upgrade industry foundations, modernise supply chains and further digitise key sectors.

In particular, from an investment perspective, technology, carbon neutrality, consumption and intelligent manufacturing will potentially provide investors with opportunities over the next five years – and possibly beyond. This has implications for a wide variety of sectors and other relevant industries in the supply chain – from semiconductors to batteries to medicine to e-commerce, and much more.

As a result, investors should seize the opportunity to invest in the China-A shares market and take advantage of domestic developments.

Riding the growth wave

This tallies with predictions that over the next five years, China could become the largest consumption market in the world.

China's relatively bright economic outlook will also support this. Official data from the National Bureau of Statistics for the first half of 2021 showed 12.7% GDP growth.

Yet various challenges still exist. Externally, these include volatile global demand and soaring prices for commodities. From an internal perspective, the Delta variant has shown the potential for widespread disruption with little warning.

Overall, however, this shouldn't derail China's growth for 2021. "Macro fundamentals and structural growth are positive," said Sau.

Investors can also count on policy solutions to shape their allocations; sustainability, for

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example, is central to the domestic market's development, spurred by initiatives to support corporate governance improvements and better disclosure.

Gaining more access

To facilitate expected flows from global institutional investors into China, the most recent of Beijing's liberalisation efforts in 2020 included combining the Qualified Foreign Institutional Investor (QFII) programme with its renminbi equivalent (RQFII), and also expanding the investment scope to include financial futures and commodity futures. At the same time, in addition to current Stock Connect Northbound scheme with Hong Kong Stock Exchange, China's regulators added a new Stock Connect scheme between Shanghai and London, to enable smoother investment flows.

While QFII is for institutional investors that meet general operational and compliance requirement, the Stock Connect Northbound scheme is open to all Hong Kong and overseas investors, requires no regulatory approval and does not compel onshore custodian or broker appointment. Comparatively, the QFII scheme enjoys a much wider investment scope than the Stock Connect Northbound scheme. Compared to a limited list of A share stocks, QFIIs can access both the primary and secondary markets such as the Shanghai Stock Exchange (SSE), Shenzhen Stock Exchange (SZSE) and SSE STAR (Sci-Tech innovAtion boaRd) Market. The same investors can also buy almost all exchange-listed or traded financial products, including equities, bonds, funds, futures and derivatives.

Quotas are further considerations. Under the QFII programme, for instance, there are no longer quota controls. Under Stock Connect Northbound, there is a market-level, daily aggregated quota for all investors of 52 billion RMB (~8 billion USD).

When it comes to fixed Income, the China Interbank Bond Market (CIBM) is the main venue, trading approximately 90% of fixed income securities in value in China.

The two access routes for global institutional investors are CIBM Direct and Bond Connect – both requiring pre-filing with the People's Bank of China (PBOC).

While neither scheme imposes an investment quota, plus both offer tax exemption on capital gains and interest income, the scope is slightly wider under CIBM Direct – going beyond just interbank cash bonds (as with Bond connect) to also allow activity including bond lending, forwards and interest rate swaps.

"We are one of the few asset managers in China holding all requisite licenses for the provision of asset management, including mutual funds, social security funds, pension insurance funds, corporate pension funds, segregated accounts, QDII and investment advisory," Executive Vice President, Dongmei Yang explained. "For global investors, we provide investment management and advisory services through QFII, Stock Connect, Bond Connect and offshore investment structures."

More meaningful in global portfolios

International pension funds have used these avenues to build Chinese investments, while emerging market indices have slowly been giving A-shares a larger weighting too.

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For example, China A shares now have inclusion factor of 20% in MSCI's indices, leading to China representing over 40% of the MSCI Emerging Markets Index. By comparison, the country has just over a 5% weighting in the MSCI All Country World Index. Other leading global benchmarks, including FTSE Russell and the S&P Dow Jones Indices, have also boosted the weighting of A shares or included them into their indices.

Similarly, the long-awaited appearance of onshore China bonds in a global index came with the April 2019 inclusion of renminbi-denominated bonds from the sovereign and some other government entities in the widely-followed Bloomberg Barclays Global Aggregate (BGA) Index.

These ground-breaking shifts across equities and fixed income give investors greater potential to diversify portfolios and improve risk-adjusted returns.

More notably, the appetite for greater China exposure should create more momentum for revising the current structural underweight within the asset allocation of many global investors. This is based on the size of China's GDP and its growth rate since China accounts for 15% of global market capitalisation and 14.5% of global GDP.

Within equities, Mercer, for example, advocates a meaningful strategic allocation to China's onshore market that could represent 5% to 10% of an overall equity portfolio.

"Global institutional investors need to allocate both to offshore and onshore Chinese stocks, as well as domestic and international China bonds, to ensure a balanced portfolio," said Sau. "Bearing in mind various risks, investors also need to work with an experienced asset manager when investing in China."

E Fund

Established in 2001, E Fund Management Co., Ltd. ("E Fund") is the largest fund manager in China with close to RMB 2.5 trillion (USD 385 billion) under management as of June 30, 2021.* It is a comprehensive investment company and it offers investment funds and solutions to both individuals and institutions investors such as central banks, sovereign wealth funds, social security funds, pension funds and large financial institutions. Long-term oriented, E Fund has been consistently delivering excellent mid- to long-term investment performances. The company is also the pioneer in responsible investments in China and is widely recognized as one of the most trusted and outstanding Chinese asset managers.