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A new approach to investing in emerging markets

March 2019

In recent times, China has been front and centre of investors' minds. In 2018 MSCI added China's onshore stock market to its suite of global equity benchmark indices. Although the initial weight of A-shares is small, the decision is an important milestone. Investors will now have to decide how to access this part of China's equity universe and how much to allocate to onshore equities. In this paper we present an alternative approach to investing in emerging markets which addresses this issue. We believe that a separate China A-share exposure in addition to an emerging markets allocation is better equipped to capture the potential of China than a purely global emerging markets strategy.

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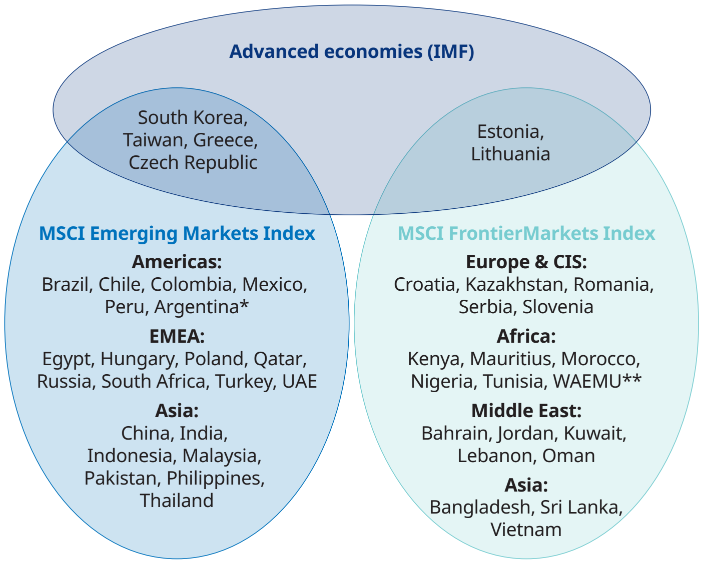
Strategist

Before discussing the China investment opportunity we will make a few comments about investing in emerging markets more broadly. The decision to invest in emerging markets is usually based on the belief that faster economic growth in these countries will lead to higher investment returns. The reality is not as straightforward.

First, investors should be careful not to confuse the term emerging market with the term emerging economy. For example, several countries which feature in MSCI's Emerging and even Frontier (the stage below emerging) market indices could be classified as advanced economies (Figure 1). South Korea and Taiwan are obvious examples.

The IMF ranks countries based on purely economic criteria, such as export diversification and the degree of integration into the global financial system. In contrast, index inclusion is governed by considerations about market size, liquidity and accessibility as well as economic status or prospects. Poor accessibility, particularly to the onshore market, is a key reason why Chinese equities have been extremely underrepresented in global equity indices.

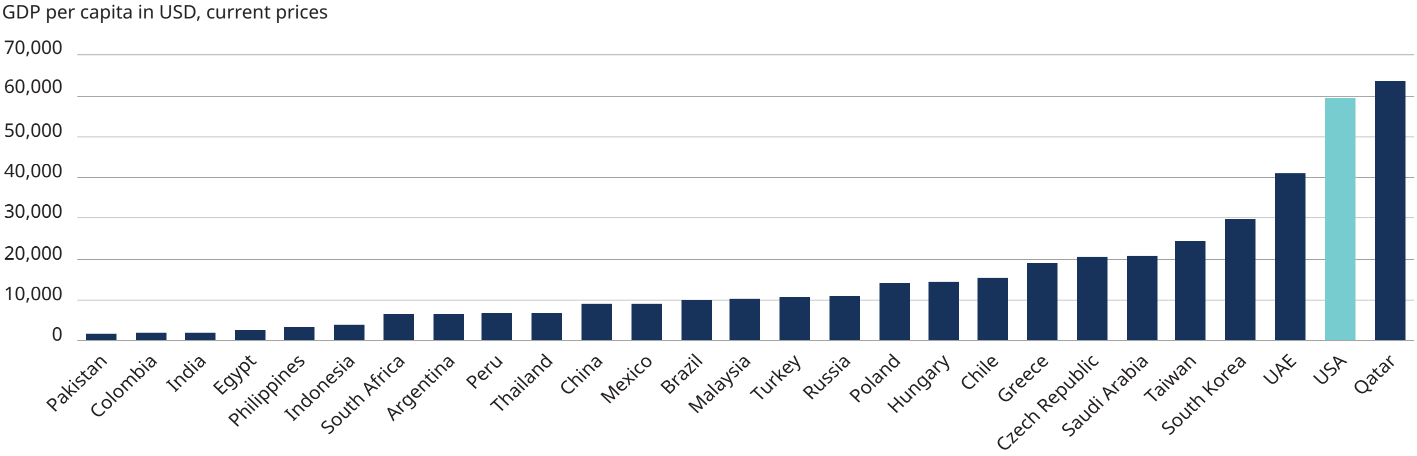
Figure 1: An emerging market is not necessarily an emerging economy



* Argentina and Saudi Arabia will be promoted to the MSCI EM Index in June 2019.
** The West African Economic and Monetary Union (WAEMU) consists of the following countries: Benin, Burkina Faso, Ivory Coast, Guinea-Bissau, Mali, Niger, Senegal and Togo.
Source: IMF, MSCI and Schroders. Data as at January 2019.

Although it is obvious that classifying markets in this way results in an index consisting of a disparate group of countries, the degree of heterogeneity is often underestimated. To illustrate this, we can look at the level of income across countries. Figure 2, overleaf, shows GDP per capita in US dollars of the constituents of the MSCI Emerging Markets Index. We have also included the US for comparison.

Figure 2: Some emerging market countries are much richer than others



Source: World Bank, Schroders. Data as at 31 December 2017.

Clearly, the dispersion in income is extremely large. At the bottom of the pack, Pakistan has a GDP per capita of $1,548. At the other end of scale, Qatar's GDP per capita of $63,506 is higher than the US. Obviously, Pakistan and Qatar have little in common. This illustrates how different emerging markets are at different stages of development and are, in reality, not all on the same development path.

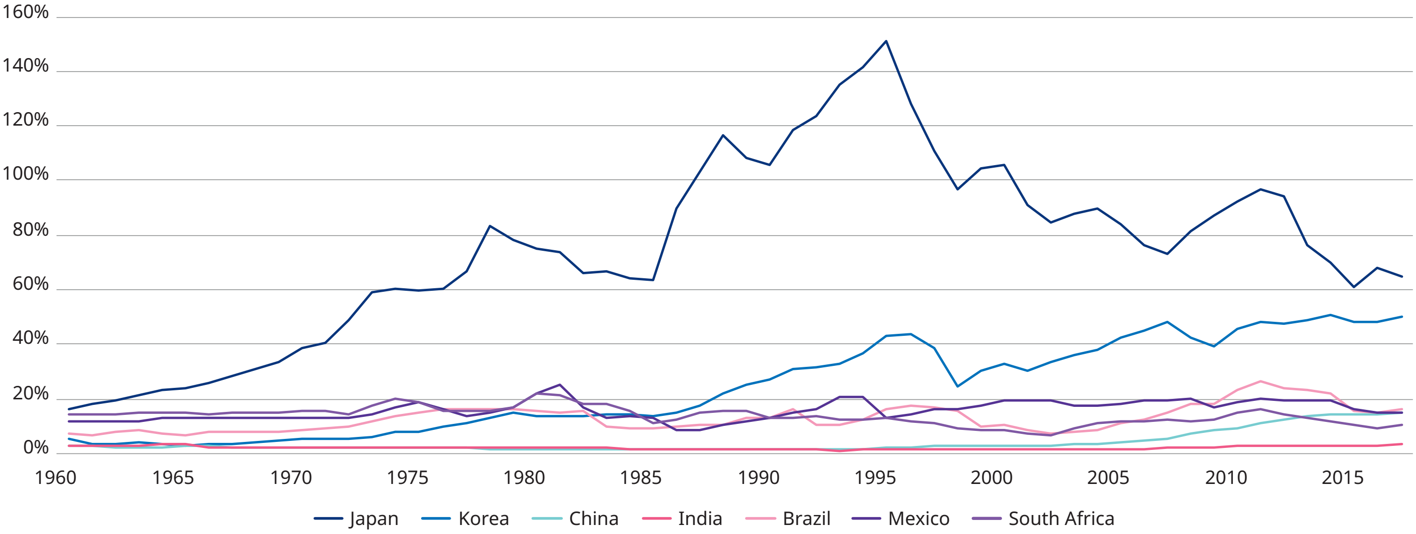
However, for a moment let's overlook the fact that these are very different countries and markets. At least, with a few exceptions, most countries in the index share one thing in common. Due to their low GDP per capita they will benefit from catch-up growth, as measured by the level of prosperity, or so the theory goes. But does this theory stand up to scrutiny? Historically, only a few countries have managed this convergence. Figure 3 shows GDP per capita relative to the US of six major emerging market countries plus Japan, a former emerging market.

In 1960, all seven countries had a GDP per capita of less than 20% of the US. Since then, only Japan and South Korea have achieved convergence, moving closer to, or in the case of Japan at times exceeding, the living standard of the US. Most other countries have failed to make sustained gains, highlighted by the relative share that has fluctuated but has not risen above 20%. As we wrote in a recent paper[1], the countries that have managed to pull off convergence have had a few characteristics in common. Specifically, they:

- started the process by becoming export power houses
- have had high saving rates and weak currencies
- have maintained a compliant and low return banking system that funnels funds for investment
- had enough coordination between government and the private sector to push exports and investment
- have imposed capital controls and have not been reliant on short-term foreign capital

1 Nicholas Field, "The convergence question", Schroders, November 2018

Figure 3: GDP per capita relative to USA



Source: World Bank, Schroders. Data as at 31 December 2017.

This list of prerequisites can explain why convergence has been so elusive in emerging markets. Most countries have failed to meet one or more criteria. In the last 30 years, China has passed most of these tests and has been a rare success story, going from 2% of the US GDP per capita in early 1990s to 15% in 2017. Looking ahead, China's growth rate is unlikely to be as high as its record since 1990, as its population ages. Nonetheless, continued strong productivity growth and a higher labour force participation rate should keep China on the convergence path . South Korea provides a good blueprint on how to continuously adjust the growth model when some of the traditional sources of growth are exhausted. For a detailed analysis of China's potential growth rate, see *Does it matter if China gets old before it gets rich?*[2]

We should add that the general lack of convergence does not mean that investors should avoid emerging markets. Figure 3 illustrates how growth rates fluctuate over time. An active investment approach allows investors to move in and out of countries tactically and to generate returns, even if there is only slow progress in the long term.

The third hurdle emerging market investors face is that the link between GDP and earnings growth is tenuous. As a result, buoyant economic growth in some emerging markets might not translate into equally fast earnings per share (EPS) growth. And the latter is ultimately what matters for investors.

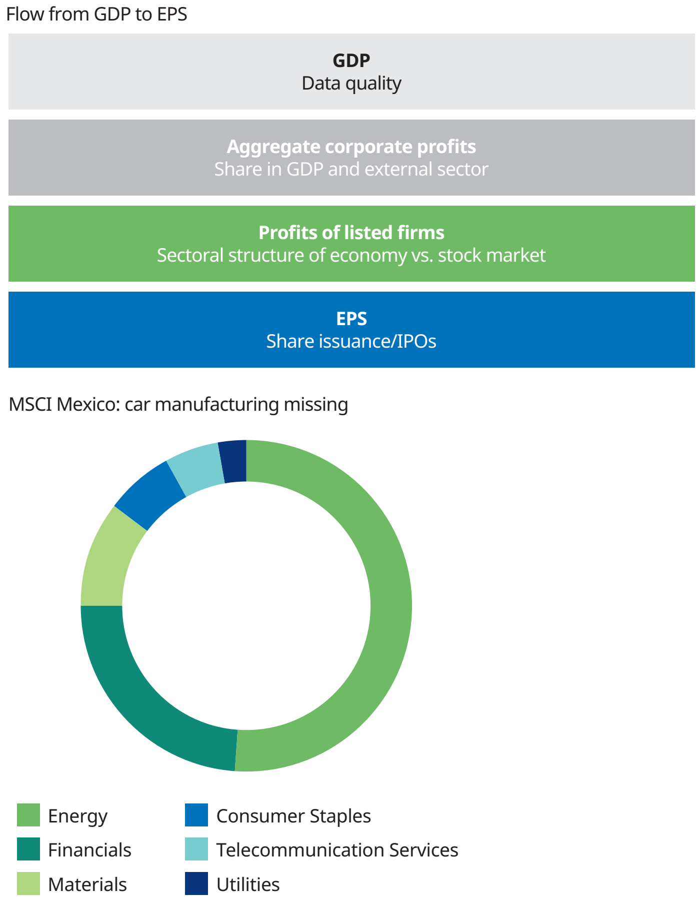
Figure 4 shows the linkage between GDP and EPS. There are possible distortions at every stage of this process. At the level of the economy itself, the reported GDP figure may suffer from measurement issues, while the share of corporate profits in an economy can change over time. In addition, the foreign exposure of economies and stock markets can vary hugely and there can be substantial differences between the industry make-up of the stock market and the economy. Even though Mexico is the 4^{th} largest car exporter in the world, there are no car manufacturers listed in Mexico's stock market.

Finally, IPOs and new share issuance can further dilute the growth mix. As a result, the EPS growth that investors eventually receive can have little correlation with GDP growth of the host country. See *GDP and earnings growth in emerging markets – a loose connection*[3] for more details.

2 Craig Botham, "Does it matter if China gets old before it gets rich?", Schroders, March 2019

3 Kristjan Mee, "GDP and earnings growth in emerging markets – a loose connection" Schroders, March 2018

Figure 4: GDP growth and earnings growth are different things



Source: Schroders, MSCI. Data as at June 2017.

Investors should consider a satellite allocation to China A-shares

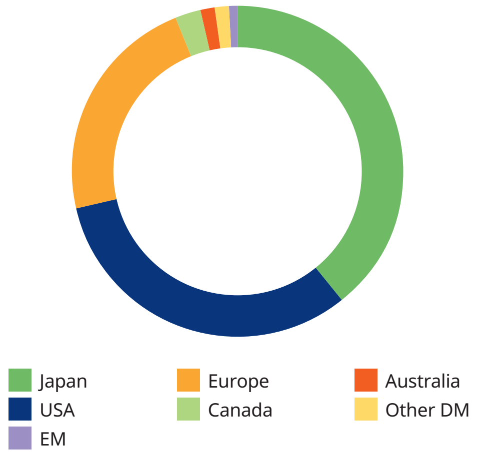
The preceding section has attempted to explain why investing in emerging market equities requires a hands-on, active, approach, rather than a static, passive, exposure. Furthermore, investors need to understand how the investment universe is changing in order to position their portfolios strategically.

As China's domestic A-share market is likely to take a central role in the investment landscape, investors will have to decide how to access this important part of the market. The size of the A-share market and the potential alpha opportunity available makes it too important to leave the decision on the size of an investor's China equity allocation to the index providers.

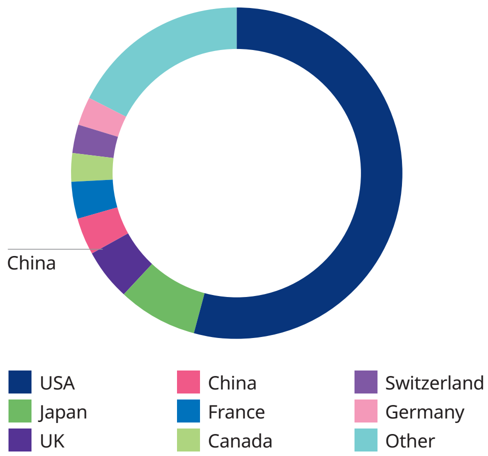
The emergence of China is not unique in a historical context, as global equity indices' country weights have changed drastically over time. That is why an approach that is heavily influenced by index construction carries the risk of allocating too much to countries with declining importance, and by implication too little to countries with increasing in importance.

Figure 5: Large index constituents have not all been winners

MSCI ACWI in 1987



MSCI ACWI in 2019

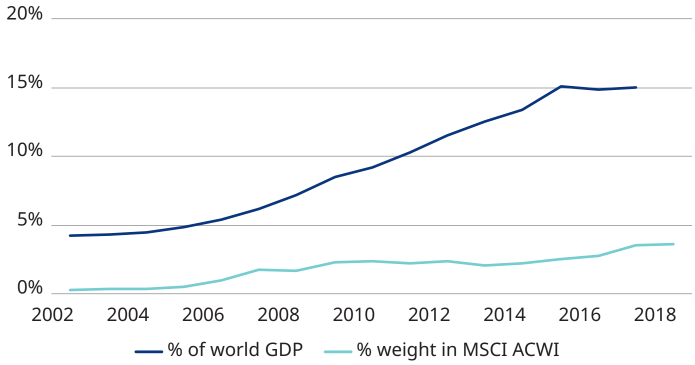


Source: MSCI. MSCI ACWI 1987 percentage weightings as at 31 December 1987. MSCI ACWI 2019 percentage weightings as at 31 December 2018.

Many investors will remember that in 1987 Japan was 39% of the MSCI All Country World Index (ACWI) (Figure 5, top chart). Japan's share peaked at 44% in 1988 and after a steady decline over 30 years, it currently stands at only 7.5% (Figure 5, bottom chart).

In 2019, the US is by far the largest constituent of the MSCI ACWI Index with 54% share. This is more than double the US economy's share of world GDP (24%), reflecting the strength and profitability of the listed corporate sector in the USA. At the same time, China's share in the MSCI ACWI Index is 3.7% (just over double the weight of Apple). As China accounts for 15% of world GDP, it is underrepresented in the index relative to its size (Figure 6). Since 2008, the gap has increased, as the part of the stock market included in the ACWI has not kept up with the rapidly expanding economy. The IMF predicts that China's share of world GDP will further rise to 18% by 2023.

Figure 6: China's share in the global economy and stock market



Source: World Bank, Schroders. GDP data as at 31 December 2017. Index data as at 31 December 2018

However, there is a good reason to believe that this discrepancy, if unlikely to disappear, will at least diminish in the coming years. The boxed section, overleaf, explains how China A-shares, the largest part of China equity universe, are now entering benchmark indices and investment portfolios. Consequently, China's weight in benchmark indices will likely increase significantly, matching more closely its economic size. Note that the rise of China differs from the fall of Japan in the sense that in Japan, valuation multiple contraction rather than changing index inclusion factor, played the central role in moving the weight.

Importantly, the inclusion of A-shares will be a drawn out process. They currently make up only 0.8% of the MSCI Emerging Markets Index. It is clear that the weight of A-shares will increase over time. MSCI has announced that the weight will quadruple over the course of 2019. Nonetheless, there is no clarity on when or if they will be fully included. We believe that rather than waiting for index providers to raise the weighting, investors should consider a satellite A-share allocation in addition to a global emerging markets mandate. Such an allocation would allow investors to access a much larger portion of the A-share market, as measured by the number of stocks and their market capitalisation. The broader opportunity set is necessary to reap the benefits of the compelling characteristics of the A-share market.

The shift to onshore investing

Most institutional investors currently invest in Chinese equities through a broad emerging markets benchmark, such as the MSCI Emerging Markets Index. Even though China has a 31% weight in the index, the exposure that index investors actually get is limited. The MSCI China Index, the sub-index of the MSCI Emerging Markets Index, is often referred as the offshore index. It consists of H-shares (mainland Chinese stocks listed in Hong Kong), Red Chips (state-owned enterprises incorporated outside of mainland and listed in Hong Kong), P-chips (private enterprises incorporated outside of mainland and listed in Hong Kong) and ADRs (Chinese stocks listed in the US).

The MSCI China Index, with its 459 constituents and $1.6 trillion market capitalisation is only about 16% of the $10 trillion China equity universe. Before 2018, the index completely excluded A-shares, mainland stocks listed in Shanghai or Shenzhen, the part of the market known as onshore. The total market capitalisation of A-shares is almost $7 trillion, making it the third largest stock market in the world after the New York Stock Exchange and the Nasdaq.

For years, foreign investors had limited access to the A-share market due to restrictions on capital flows. This has prevented A-shares from becoming a part of institutional investors' portfolios. A major change happened in 2014 with the introduction of the Shanghai-Hong Kong stock connect, which allows qualified foreign investors to trade eligible A-shares without the need for a local Chinese licence. The Shenzhen-Hong Kong stock connect followed suit in 2016. For the first time, investors could access the onshore market without major restrictions.

Index providers have taken notice of this liberalisation. In 2018, MSCI announced that it would add China A-shares to its suite of global benchmark indices. Inclusion is taking place on a phased basis: as of February 2019, 5% of the full market capitalisation of eligible large-cap A-shares is included in the indices. The 5% inclusion factor will increase to 20% over the course of 2019. MSCI is also considering including A-shares of mid-cap companies under the same terms as large-cap A-shares, as well as stocks listed on the technology-focussed ChiNext market.

After full A-share inclusion, if it ever happens, the weight of China in the MSCI ACWI Index would be around 7%, matching the size of Japan. Please see *Weightlifting China – how big will it get?*[4] for more details.

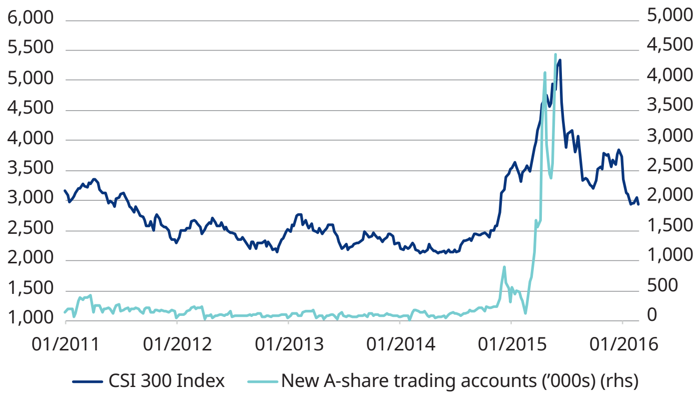
4 Duncan Lamont, "Weightlifting China - how big will it get?", Schroders, February 2019

Opportunity in the A-share market

The characteristics of the A-share market differentiate it from most global peers. Historically, despite its relatively large size, the stock market has not played a big role in China's economy. For example, equity issuance has accounted for less than 5% of total corporate fund-raising[5]. Importantly, the market has been dominated by retail investors, who in 2018 accounted for 86% of the total trading volume. This has made the A-share market volatile and susceptible to wild swings in sentiment.

This issue was most acute in 2014/15. Figure 7 shows how, in late 2014, the CSI 300 Index (the dark blue line) started to rise fast after staying range-bound for years. Hoping to jump on the bandwagon, retail investors began opening new stock trading accounts. As stock prices exploded higher, more and more people wanted to participate. At one point in 2015, more than 4 million new accounts were opened every week (Figure 7, the light blue line). Consequently, stock prices became detached from fundamentals, driven by speculation. Inevitably, the bubble burst in June 2015 and the index fell close to 50% over the following months.

Figure 7: Retail buying of A-shares exaggerates volatility



Source: Schroders, Thomson Reuters Datastream. Data from January 2011 to February 2016.

Past performance is not a guide to future performance and may not be repeated.

Although retail investors will remain an important influence on the market, institutional participation in the A-share market is likely to rise. Research shows that non-professional investors are highly affected by past performance in their purchase decision and exhibit emotional bias by selling winning investments and holding on to losing investments[6]. This behaviour should provide institutional investors who operate rigorous investment processes significant opportunities to add value in A-shares.

5 Arthur R. Kroeber, "Making sense of China's stock market", The Brookings Institute, July 2015

6 Brad M. Barber and Terrance Odean, "The Behaviour of Individual Investors", September 2017

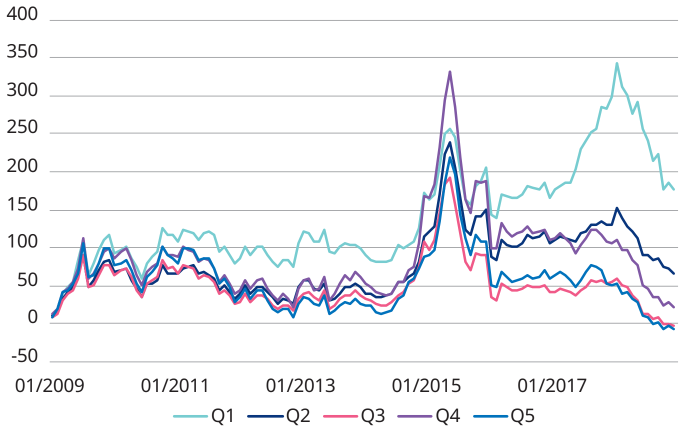
We have recently observed that some key fundamental factors, such as return on equity (ROE) and dividend yield, as well as valuation multiples, are becoming more important drivers of returns. Figure 8 shows the total return of the MSCI China A Index, broken down into quintiles based on ROE (upper chart) and P/E ratios (lower chart) of individual stocks. Before 2015, there was little differentiation in the performance, highlighted by the clustering of returns. This means that investors were not rewarded for buying cheap stocks or stocks with high ROE.

In the last three years, there has been a visible shift – return dispersion has increased significantly. The stocks with a high ROE have outperformed the stocks with a low ROE. In the same vein, cheap stocks have outperformed expensive ones. The efforts of fundamental investors are now being rewarded by the market, as valuations and corporate profitability are gaining a greater influence on returns. This development is similar to what happened in South Korea and Taiwan 20 years ago as the two markets matured.

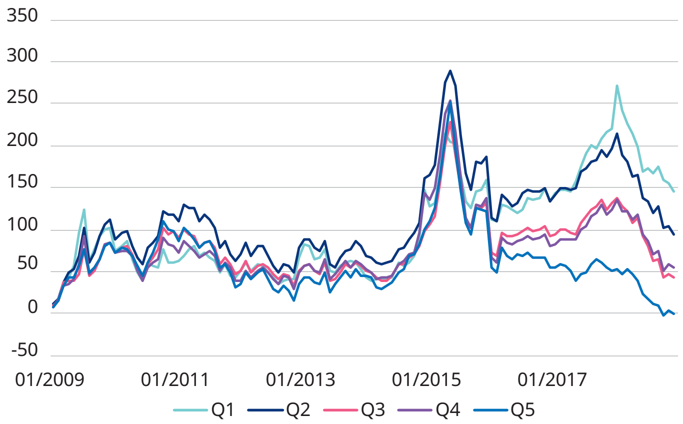
Figure 8: A-share stock returns are now more driven by fundamental factors

MSCI China A Index

Return on equity (ROE) (Q1 = highest ROE, Q5 = lowest ROE)



Price-to-earnings ratio (P/E) (Q1 = lowest P/E , Q5 = highest P/E)



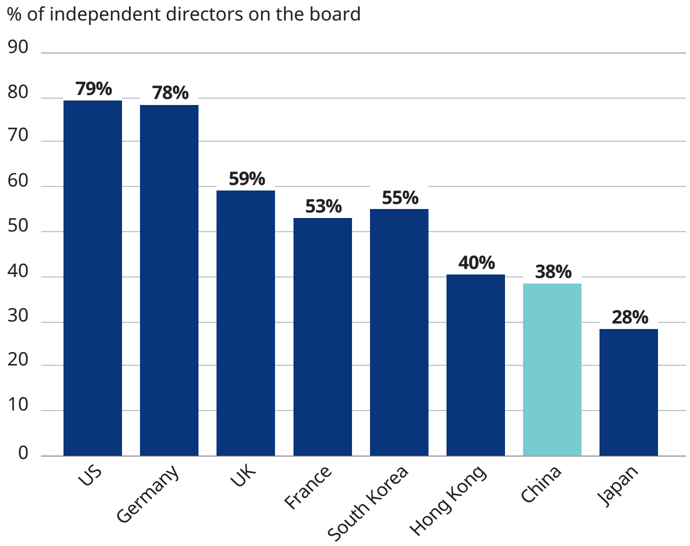
Source: Schroders, FactSet. Data as at December 31 2018

Past performance is not a guide to future performance and may not be repeated.

Besides the high share of retail investors, another hallmark of the A-share market has been low corporate governance standards. This has contributed to market volatility and posed heightened corporate governance risk for investors. Low governance standards can be broadly explained by the fact that conventional checks and balances have been weaker than in other global markets.

The presence of independent directors on the boards of A-share companies is limited compared to other countries (Figure 9). Moreover, independent directors usually get paid relatively little. So there is less oversight of executive management by company boards. Externally, companies can get away with questionable accounting practices. Auditing standards in China are still poor compared to the rest of the world, highlighted by generally low auditing fees. Finally, as state owned enterprises (SOEs) account for 30% of the market capitalization of the A-share market, there is potential conflict between the interest of company's minority shareholders and the interests of the state.

Figure 9: Percentage of independent directors is still relatively low compared to other markets

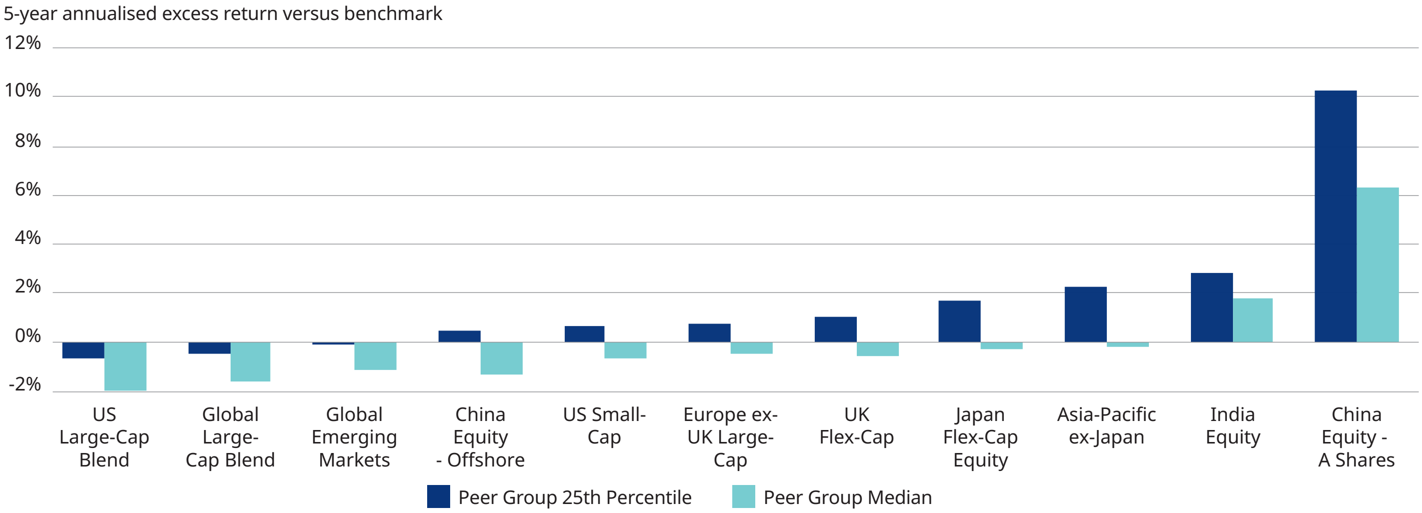


Source: Schroders, Thomson Reuters Datastream. Data as at February 2019.

The good news is that the governance standards have started to improve, driven by the institutionalisation of the A-share market. Institutional investors are emerging as a group powerful enough to steer the practice of corporations. Furthermore, more and more companies are now audited by recognised international auditing firms.

The A-share market, for the reasons discussed above, has been a fertile ground for active managers. Figure 10, overleaf, shows that over the last 5 years, the median China A-share manager has been able to earn an annualised excess return of 6.3% after fees. This is an exceptionally high level by global standards. Median excess returns have been close to zero or negative in most global equity categories over the same timeframe.

Figure 10: Significant alpha in the A-share market



Source: Schroders, Morningstar. Includes open-ended EAA equity funds. Returns are shown net of fees. Data as at 31 December 2018.

Past performance is not a guide to future performance and may not be repeated.

Passive approaches, conversely, have lagged the benchmark, as shown by the ETF performance in Figure 11. Most developed market ETFs have underperformed the indices by the amount implied by the management fee. In rare cases, some ETFs have actually outperformed their benchmarks. For China A-shares, we are showing the performance of ChinaAMC CSI 300 Index ETF. It is the largest A-shares ETF tracking the CSI 300 Index that is available for offshore investors. Over the last three and five years, it has underperformed the CSI 300 Index by -1.3% and -0.9% respectively. Moreover, the underperformance is greater than what would be implied by the expense ratio (0.7%), pointing at the high cost of passive replication of the A-share market.

Figure 11: Passive has not delivered in A-shares

Source: Schroders, Bloomberg, ETF providers. Passive returns taken from representative fund. Representative Passive Funds: Asia ex Japan – Lyxor MSCI AC Asia-Pacific ex Japan ETF, China A-shares – ChinaAMC CSI 300 Index ETF, China Offshore – iShares MSCI China ETF, GEM – iShares MSCI Emerging Markets ETF, Global – iShares Core MSCI World ETF, India – iShares MSCI India ETF, Japan – Lyxor Japan (Topix) DR ETF, Pan Europe – iShares MSCI Europe ETF, South Africa – iShares MSCI South Africa ETF, UK – SPDR FTSE UK All Share ETF, US – Vanguard 500 Index Fund. Data as at 31 December 2018.

Past performance is not a guide to future performance and may not be repeated.

A-shares in global equity portfolios

A-shares would be an important addition to global equity portfolios due to their high diversification benefit. Figure 12 shows that the MSCI China A-share Index has half the correlation with global equities than the MSCI China index.

As the share of A-shares is gradually increasing in global benchmarks, the diversification benefit will decline over time as A-shares become more integrated with the global investing universe.

Figure 12: Onshore China equities have a low correlation with global markets

	MSCI World	MSCI EM	MSCI ACWI	MSCI Emerging Asia	MSCI Asia ex-Japan	MSCI EM ex-China	MSCI China	MSCI China A-Share
MSCI World	1.00							
MSCI EM	0.85	1.00						
MSCI ACWI	1.00	0.88	1.00					
MSCI Emerging Asia	0.80	0.97	0.83	1.00				
MSCI Asia ex-Japan	0.82	0.97	0.85	0.99	1.00			
MSCI EM ex-China	0.85	0.99	0.88	0.95	095	1.00		
MSCI China	0.70	0.83	0.73	0.84	0.85	0.77	1.00	
MSCI China A-Share	0.35	0.43	0.37	0.45	0.46	0.38	0.56	1.00

Source: Schroders, Thomson Reuters Datastream. Data as at January 2019.

Conclusion

China's growing importance in the global economy, together with efforts to open up Chinese financial markets to foreign capital, make the decision on the size and composition of an allocation to China equities too important to be left to index providers. As China takes a larger share in portfolios, investors should consider a more proactive approach, especially in the light of the unrivalled alpha opportunities in China A-shares. We believe the most efficient way to gain a desired exposure is via a separate satellite A-share allocation on top of an existing global emerging markets mandate.

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