Equity Exposure to China

Over the past decade, investment managers of all styles have grappled with the issue of investing in China, a country that represents significant exposure within emerging markets equities and presents unique geopolitical and governance challenges. Views on investing in Chinese equities are divergent—there have been “persistent bulls,” “perma-bears,” and managers with alternating views. No matter which investment manager is selected, long-term institutional investors should decide whether or not they want direct exposure to China, and if so, how much.

For investors contemplating removing direct exposure to China, below are potential advantages and disadvantages to consider.

Potential Advantages to Removing Direct China Exposure:

- Removes direct exposure to potential risks created by an authoritarian regime with a history of sudden interventions in capital markets to the detriment of shareholders.
- Reduces exposure to the impact of a potential conflict with Taiwan.
- Reduces headline risks associated with direct exposure to the country.

Potential Disadvantages to Removing Direct China Exposure:

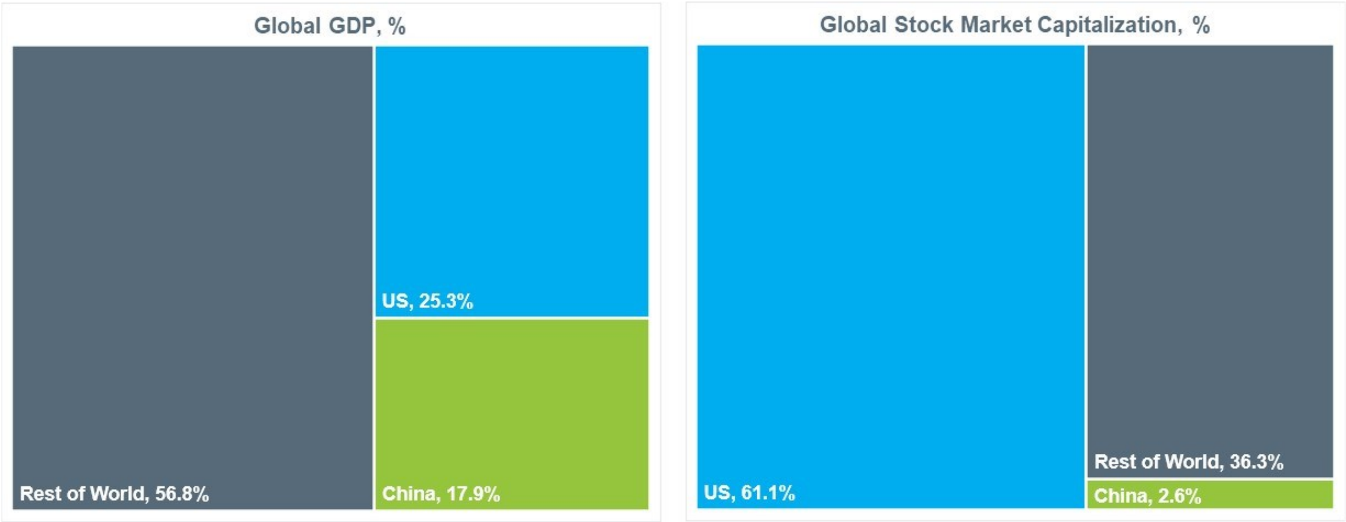
- Limits exposure to a country with above average expected return assumptions and reduced opportunity set for alpha generation.
- Reduces diversification, given China’s differing correlations with other Developed/Emerging Markets countries.
- Continued exposure to the country through other companies or countries held in the portfolio.

This paper explores three core aspects of this decision: market structure, expectations for performance within Chinese equities, and potential investment approaches.

Economic Footprint versus Stock Market Capitalization

The disconnect between the Global GDP contribution from China and its relatively limited share of the global stock market capitalization can take some investors by surprise. Given the use of non-equity based financing of corporate investment and limited allowance of foreign investment in the local stock exchanges, China represents less than 3% of the total global market capitalization, as represented by the MSCI All Country World Investable Market Index. China’s contribution to Global GDP in 2022, on the other hand, was almost 18% (see **Figure 1** on the following page).

Figure 1: Contribution to Global GDP and Global Stock Market Capitalization



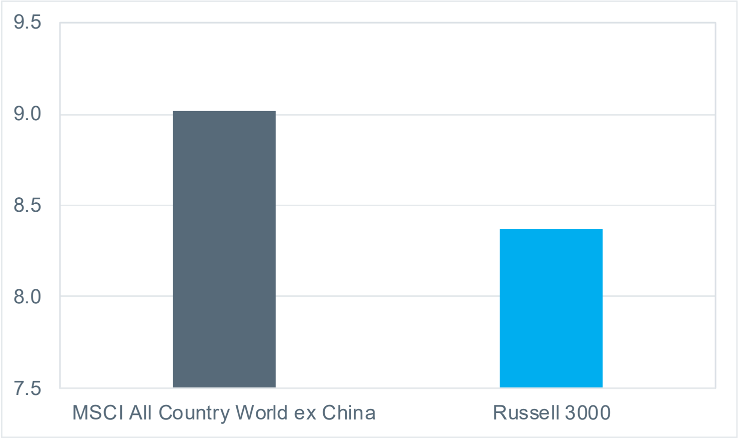
Source: World Bank (GDP, 2022), MSCI (Market Cap, December 31,2023)

For investors with dedicated emerging markets allocations, China exposure is a more acute risk to consider. Based on data from Morningstar, the MSCI Emerging Markets Investable Markets Index, the country represents a weight of 24% as of December 31, 2023 (notably given the associated risks linked to China, Taiwan represents 17% of the same index). Among emerging markets countries where higher risk levels are expected relative to developed markets, China's geopolitical and governance risk stands out because of the weight of the country within emerging markets benchmarks and its broader links to the global economy.

Direct and Indirect Risks

For investors reducing their direct exposure to investments in China, it will be difficult to remove all investment risks related to the country. Aside from residual impacts on other investments from trade negotiations or sanctions, the US and Global stock markets have notable revenue exposure to China. Based on estimates from Morningstar, exposure of companies within the MSCI ACWI (ex China) and Russell 3000 indices is in the 8-9% range.

Figure 2: Revenue Exposure to China, %



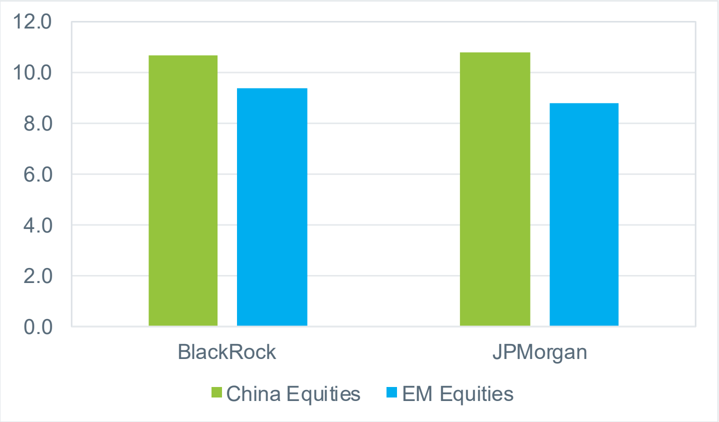
Source: Morningstar Direct. As of December 31, 2023.

These revenue levels likely discount the true interconnectedness of the operations of non-Chinese companies and the country given its role as a manufacturing and supply provider. For example, despite more recent efforts to reduce reliance on the country, it has been reported that over 80% of iPhones were manufactured in China,[1] making the associated risks particularly acute for Apple. In short, China is expected to continue being a driver of global economic trends and have an impact on companies outside of the country, making it unlikely that investors can fully avoid indirect risks without a significant departure from traditional public equity exposure.

Alpha or Beta Opportunity?

Investors looking to invest in China or avoid the country altogether each have data to support their views. However, the decision to be active or passive within Chinese equities is more clear. With regard to Chinese equity beta exposure, two notable investment managers, BlackRock and JPMorgan, recently released updated return assumptions for China and broad emerging markets, among other forecasts. Each firm forecasted a higher long-term expected return for China versus the broader emerging markets opportunity set. However, each also highlighted a wide range of outcomes around these projections. At least directionally, these forecasts indicate the potential for higher future returns in China relative to other emerging countries.

Figure 3: 15-Year Expected Return Assumptions, %



Source: BlackRock, JPMorgan. Assumptions as of September 30, 2023.

The realized results for investing in Chinese equities must also be considered. The returns for the MSCI China Index have lagged the MSCI Emerging Markets Index over the past 20+ years. While there have been spurts of outperformance from Chinese equities, there have been extended periods of underperformance as well. Investors looking to limit or eliminate their exposure to Chinese equities can point to the real risk of realized returns falling short of higher expected returns.

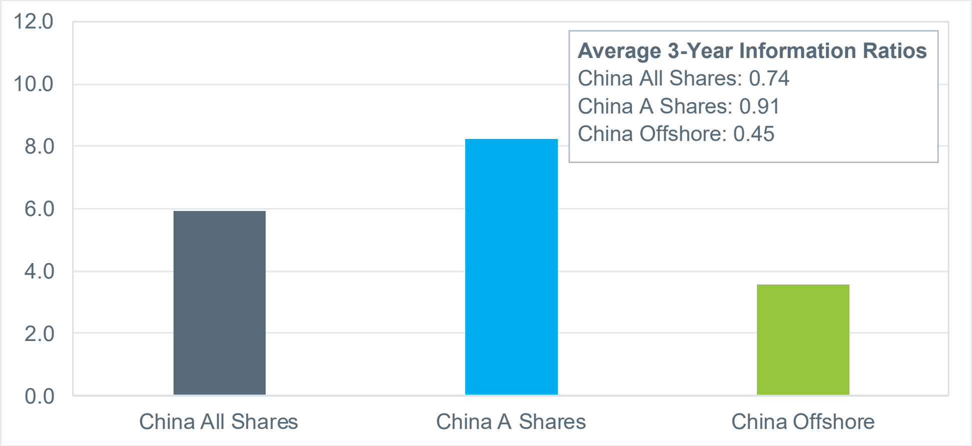
Figure 4: China versus Broad Emerging Market Returns

Source: MSCI. As of September 30, 2023. Performance is annualized for periods greater than one year.

[1]Wall Street Journal, December 2022, www.wsj.com/articles/apple-china-factory-protests-foxconn-manufacturing-production-supply-chain-11670023099

The historical and prospective returns for exposure to China are mixed. However, the potential for adding value through active management within the country appears to be substantial. The below chart shows the average rolling 3-year excess returns of different groups of China-focused strategies versus their preferred benchmarks. Generally, the average levels of excess return indicate an ability by active management to add value within the country at an attractive level of efficiency, as shown by the average information ratios for each group.

Figure 5: Active Management Results
(Average 3-Year Excess Returns, Dec. 2012-Sep. 2023)



Source: eVestment.com. As of September 30, 2023. Excess returns calculated using gross of fee returns versus stated preferred benchmarks.

Allocation Options

As previously stated, China does not represent a significant weight in the MSCI ACWI IMI, but it is a significant component of the MSCI Emerging Markets IMI, representing a 24% weight as of December 31, 2023, and with recent periods where it was nearly 40% of the index. This larger weight within emerging markets creates an issue for investors with dedicated emerging markets strategies, but are looking to limit exposure to the country.

To date, RVK has guided several institutional investors through this complex decision-making process. Below are some potential portfolio structure options to consider that have been borne out of those discussions.

- **China Offshore vs. China A:** For investors interested in direct investments in China, there are multiple strategies available focused solely on China Offshore strategies (H-shares) or China A-shares (domestic exchanges), or strategies which consider both types of direct investments. When developing alpha assumptions it is important that investors understand which market is being targeted, as they can vary significantly.
- **Emerging Markets ex China:** There are a growing number of emerging markets strategies which strictly exclude China from the opportunity set. The deepening of this universe of options presents the potential for investors to maintain their existing public equity structures.
- **ACWI ex USA:** Considering a broader international strategy, rather than a dedicated emerging markets allocation, can reduce the percentage that China represents in any given strategy. Additionally, should an investor decide to remove China, it would not disrupt a broader ACWI ex US strategy to the same degree when compared to a dedicated emerging markets strategy.

Conclusion

Understanding the impact on the long-term expected return and risk assumptions for global equities should be a guiding light for investors. Whether an investor chooses to invest or divest in Chinese equities, the decision process should follow a comprehensive review of the potential benefits, risks, and drawbacks of each scenario. With either choice, the strategies selected to either access or avoid Chinese equity exposure can dictate whether the decision ultimately positively or negatively impacts long-term portfolio results.

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