SPONSOR'S COMMENT

HOW TO CAPTURE CHINESE ALPHA THROUGH EXCHANGED-TRADED FUNDS

Stock Connect expansion makes it easier for foreign investors to take part in an increasingly important market.

CHINESE exchange-traded funds are a good way for reserves managers to rebalance their portfolios to better reflect the global economy.

At the end of May 2022, the Chinese and Hong Kong securities regulators announced that they would be including eligible ETFs into the 2014 Stock Connect programme. Six years after the move was first mooted, the inclusion had been decided in order 'to expand the variety of traded products and provide more investment opportunities and convenience for domestic and overseas investors,' according to the China Securities Regulatory Commission and Hong Kong Securities and Futures Commission in a joint statement.

While there are certain limiting eligibility requirements, it is a momentous occasion, not least because it opens China's fast growing onshore ETF market to global institutional investors for the first time.

One important subgroup of institutional investors are those who manage the official reserves of countries and central banks around the world. These have long been following a diversification path. Not only have they been increasing their exposure to equities, they have also been broadening their exposure geographically.

ETFs and other equity index strategies have deservedly caught reserves managers' attention as a low-cost way to increase their equity exposure and risk profile, while also providing diversification, liquidity, flexibility, accessibility and transparency.

At the same time, many reserves managers are aware that their overall asset exposure needs to better reflect the composition of the global economy, in particular by increasing their exposure to China.

According to research by Greenwich Associates and analysis of the annual reports of several asset owners, 70% of global institutional investors say emerging market equity strategies are their primary, and sometimes only, source of Chinese exposure. Their average exposure to China is only 4.6%, with Asian investors having the highest (10.4%) and European investors the lowest (1.9%) exposures.

Much of this imbalance is due to the disconnect between China's gross domestic product weight and its presence in global indices. China currently represents 16% of global GDP weight but makes up only 4% of the cap-weighted index. Looked at through a purely emerging markets lens, China is 40% of global emerging market GDP but constitutes only 30% of the relevant index. This means that both global and emerging market funds are underweight in Chinese stocks compared to the Morgan Stanley Capital International all country world index and the MSCI emerging market index.

Chinese ETFs are therefore a perfect way for reserves managers to rebalance their portfolios to better reflect the global economy, while increasing non-correlated alpha with a low cost, liquid instrument.

China's ETF market is ready for this global institutional attention. Looked at from both a five- and ten-year basis, China's ETF market has grown rapidly. From 2011-21, China's ETF assets under management grew to Rmb2trn ($310bn), with an annualised growth rate of around 39%. The trade volume of ETFs also grew from around 0.5% to over 3% of the total A-shares market from 2017-21. Over the past year alone, institutional holdings of Chinese ETFs grew by almost a quarter.

China's ETF market is also becoming more sophisticated and more efficient. Analysing the return distribution of the market in total from 2020-22, returns delivered by Chinese ETFs have become much less dispersed. At the same time, fund flow analysis shows that in 2021 investors were diversifying their positions from investing in ETFs that had delivered the highest returns to investing in ETFs that had delivered lower returns. This shows sophisticated behaviour.

A further compelling aspect of China's ETF market is that the indices it tracks have low correlations with other global indices and markets. For example, the performance of the China Securities Index 300 has only a 20% correlation with the S&P 500 and a 33% correlation with the MSCI ACWI. These low correlations between A-shares' broad-based indices with other markets are due to the idiosyncratic characteristics of China's economy. As these will remain, so the low correlations are likely to be sustained.

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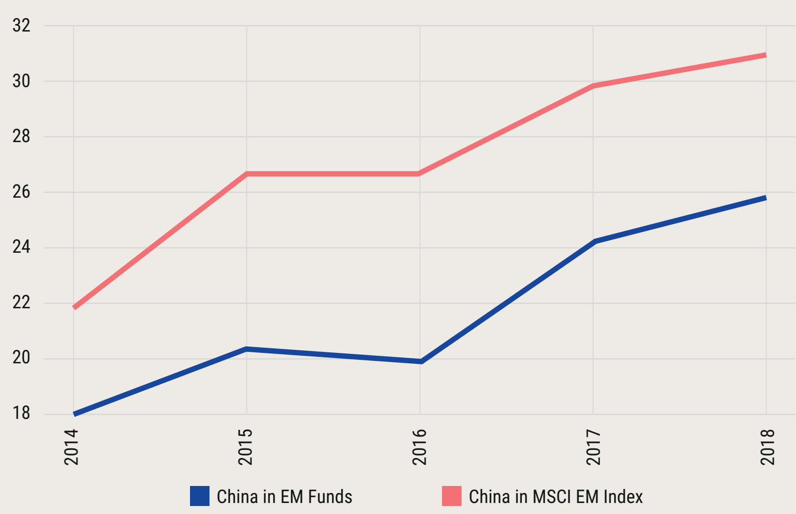
A-shares are the best expression of China's diverse and growing economy. The CSI 300 index is one of the indices that best captures this market. It consists of the 300 largest and most liquid A-share stocks, aiming to reflect the overall performance of China's A-share market. It consistently delivers higher than GDP growth investment returns. For example, as of the end of 2021, the 10-year annualised return of CSI 300 is 9.9% compared to 8.9% nominal GDP growth. The sector distribution of the CSI 300 is aligned to the underlying market values with financials, technology, industrial and consumer sectors being the four largest sectors in the index. For investors wanting more focus on emerging industries, the ChiNextSTAR 50 index allows investors to capture securities ranked top in terms of market capitalisation from both the Shenzhen Stock Exchange ChiNext and Shanghai Stock Exchange STAR boards.

Reserves managers are also increasingly expected to incorporate environmental, social and governance considerations into their allocations. This is very much aligned with China's overall focus on sustainability within its equity markets. According to China Securities Index, the ESG ratings of constituents of the CSI 300 range from triple-A to C with the highest concentration from B to triple-B. The overall median score is 0.91 out of 1.0. For ChiNextSTAR 50, the overall median ESG score is 0.9 but the proportion of high ESG ratings (triple-A/AA) is 21%.

Chinese ETFs are a product whose time has come. Investors can now access them through the Stock Connect scheme. With increased correlations between global asset classes, the need for diversification for reserves managers has never been higher. At the same time, ETFs as a product need to be large and liquid enough to support the needs of global institutional investors. They also need to have ESG woven into their DNA to match the expectations of global investors. Chinese ETFs meet these requirements and should form an increasingly valuable part of reserves managers' allocations. •

1. MARKET CAPATALISATION WEIGHT OF CHINA

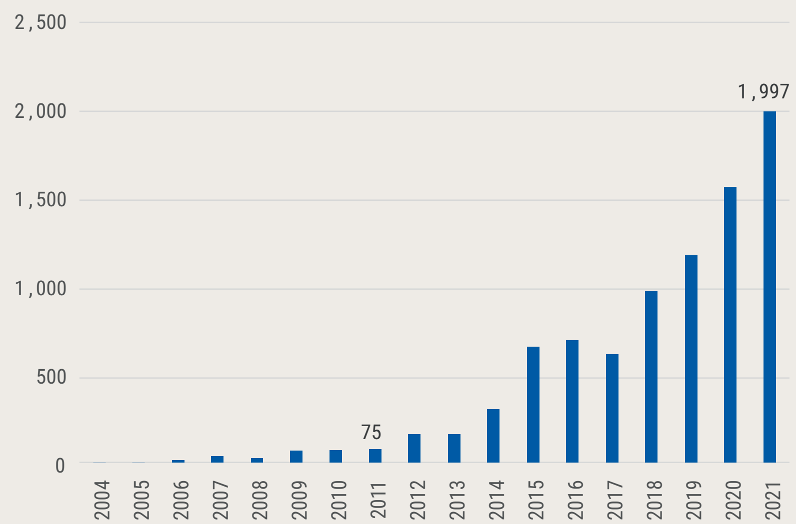
%



Source: MSCI, Lipper

2. CHINA ETF MARKET SIZE

RMBbn



Source: Wind, data as of 2004/1/1-2021/12/31

About E Fund Management

Established in 2001, E Fund Management is the largest fund manager in China with over Rmb2.7tn ($412bn) under management. It is a comprehensive investment company and it offers investment funds and solutions to both individuals and institution investors such as central banks, sovereign funds, social security funds, pension funds and large financial institutions. Long-term orientated, 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 recognised as one of the most trusted and outstanding Chinese asset managers.*

** AUM is a preliminary estimate and includes subsidiaries. Data as of 30 June 2022.*