China A-Shares: Why Now?

Figure 1: China A Shares Performance*

*Total return of MSCI AC World and MSCI China A indices between Q304 and Q324. Source: MSCI

China's onshore equities, commonly known as "A-shares," represent a significant opportunity for investors, despite recent challenges. These RMB-denominated securities, which trade on China's domestic stock exchanges and are tracked by MSCI, have underperformed global markets over the past three years, ending September 30th, 2024. During this period, MSCI China A shares declined by 7.9% annually, while the MSCI ACWI gained 8.7% per year. However, despite this underperformance, the long-term perspective is more promising. Over the past 20 years, MSCI China A index has achieved an annualized return of 7.5%, a performance that remains competitive with MSCI ACWI's 9.1%, which has been heavily influenced by the U.S. market's growth (refer to Figure 1 above).

There are many reasons accounting for China's under-performance: from the government's excessively tight Covid policies since 2020, a crackdown on the tech sector, to the debt overhang in the property sector and falling real estate prices. This is further exacerbated by challenging demographics and rising geopolitical risks.

Why invest in A-shares now? We feel there are four key factors that are under-appreciated by investors.

1. China A shares are trading at a significant discount relative to its own history. This discount level has historically pointed to strong forward returns
2. China A shares offer high and increasing diversification benefits to global investors
3. Bolder policy support is underway to stimulate the economy and importantly encourage better capital allocation by companies, of which dividends and share buy backs are increasingly important
4. China A shares offer great scope for stock selection and alpha generation given the inefficiency of the asset class

China A-Shares are significantly under-valued

As of 3Q 2024, China A shares are trading at a trailing P/B of 1.6, at a significant >1 standard deviation below its historical 10-year average. Historically, this level of valuation has acted as a floor to further sustained downside. Objective historic return analysis undertaken by us indicates that buying when the index is below normal range levels (at greater than 1 standard deviation below its mean) would have generated annualized returns of 22% in the 3-year period ahead (more details in Table 1).

Another important by-product of China A shares' underperformance has been the decoupling of the asset class' correlation with global markets. Whilst China equities have historically demonstrated amongst the lowest correlations to global markets, this has become even more pronounced in the most recent 3 years as illustrated by Figure 2.

Table 1: MSCI China A returns on P/B valuation bands

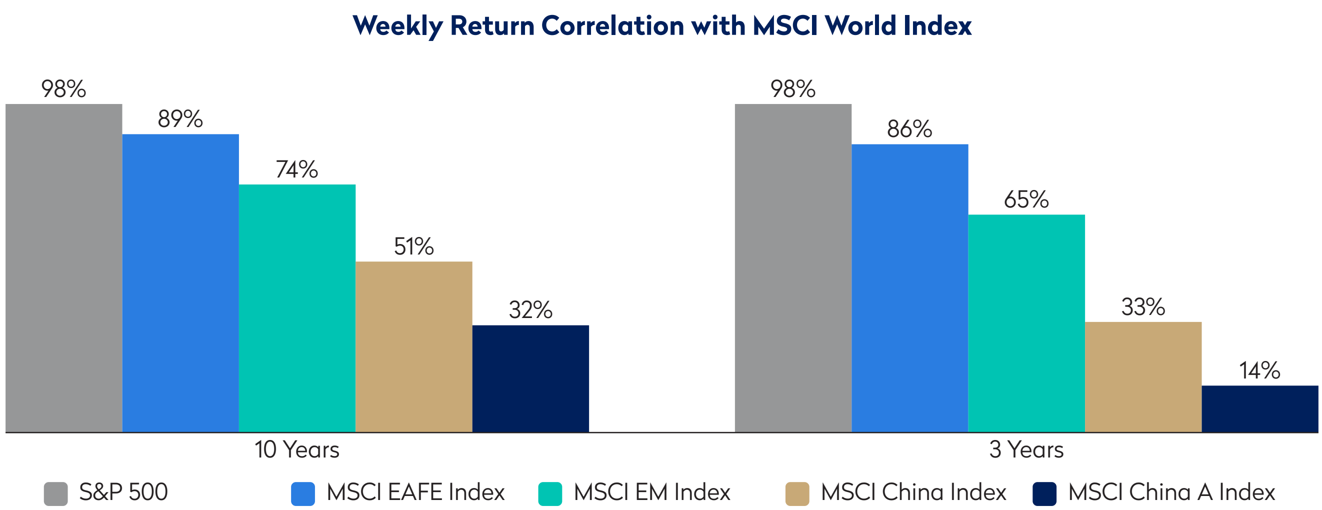
MSCI China A Index Returns based on Starting Valuation

P/B STD Band	3 Year Average Fwd Return Annualized	Minimum Return	Maximum Return
Below -1 Std	22%	17%	26%
-1 Std to Mean	4%	-14%	25%
Mean to +1 Std	-9%	-16%	-4%
+1 Std and Above	-14%	-17%	-11%

Taking rolling 10-year MSCI China A share index level P/Bs from Q304 to Q324, we calculate the forward 3-year returns per annum, at varying bands of P/B as determined by standard deviation around the mean. Buying the MSCI China A share index at below 1 standard deviation to the mean on this basis, would have returned 22% per annum in the 3 year period thereafter.

China A-Shares offer substantial diversification benefits

Figure 2: Major global markets' correlation to MSCI World



Data as of September 30, 2024. Source: MSCI and S&P

Within China, MSCI China A shares exhibit even lower correlation to global markets compared to MSCI China. MSCI China index excludes the large index weights of foreign currency denominated internet names, which also feature heavily in the EM index. As a result, A shares offer a broader and much more diverse exposure to industries and companies across China, of which a tiny 2.9% is included in MSCI ACWI[1] given low index inclusion factor to China A shares to date.

[1]Data as of September 30, 2024

China A Shares: To provide higher returns through dividends and share buy backs

The weak performance of the broad economy and stock markets have not escaped the attention of policy makers in Beijing. Policy makers are increasingly turning their focus to a more sustainable form of value creation, shifting corporate China's focus away from traditional metrics of growth and high levels of investments towards profitability and return on invested capital to shareholders.

Policies targeting state-owned enterprises (SOEs) began as early as November 2022[2] when China's securities regulator, the CSRC, shifted the assessment framework for SOEs from revenue growth targets to profitability and cash-generation metrics, including ROE, cash conversion, and dividends. This has been followed by the State Council's Nine-Point Guideline plan introduced in April 2024. The plan introduced policies to encourage higher dividend payments and improve shareholder rights for the broader market. We are already seeing this take effect as the dividend pay-out ratio at the index level for MSCI China A is estimated to rise to 37% for 2024[3], from an average of 30% in the past decade, according to FactSet data. We believe that dividend pay-outs will continue to rise in the years ahead. Relative to the 47% pay out offered by MSCI EM excluding China, there is significant scope for A-Share companies to raise the pay-out ratio further and for dividends to outgrow earnings over the years to come.

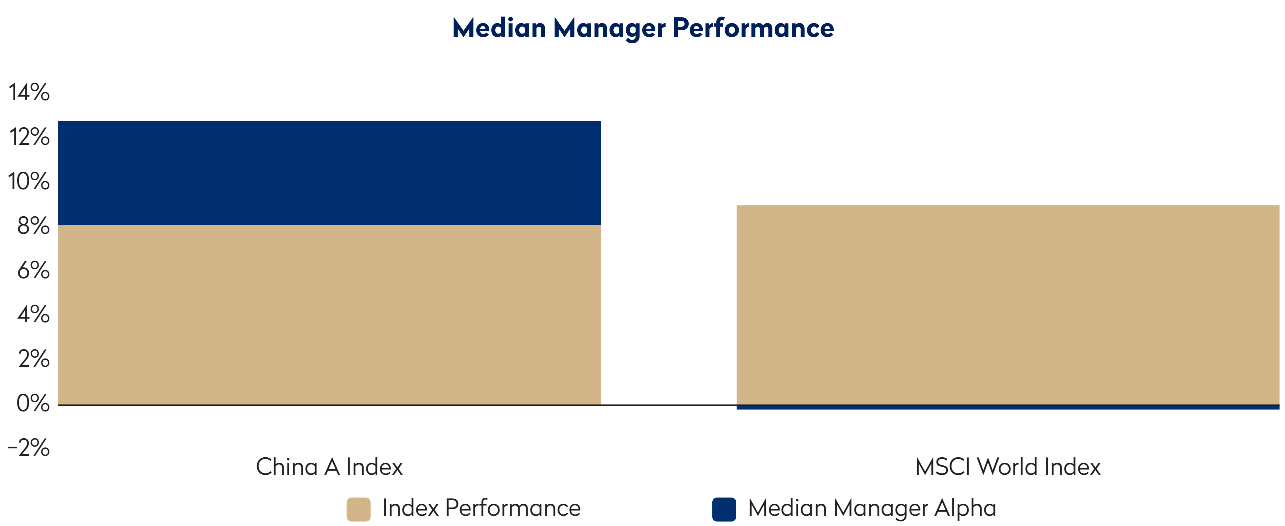
Very recently in September, the PBOC announced a sizable funding package of lending to institutions to invest in Chinese equities, and to companies to buy back their own shares. Indications are that further fiscal support towards consumers would be forthcoming, underscoring the government's concern for the economy and stock market.

For the average Chinese household, most of the wealth has traditionally been invested in the property market given the closed capital system adopted by China. Within such a closed system, there is significant scope for more allocation to equities, particularly if the outlook for real estate prices remains challenging. This would be in line with the government objective of fostering a viable self-funded pension system that can present an alternative to the property market and reduce the government's own fiscal burden. If over time, both companies and domestic investors adopt a long-term mindset that places greater emphasis on sustained dividend returns as opposed to short term share price moves, market volatility and risk premium may also decrease.

China A Shares: Meaningful alpha potential for active managers

Active managers possess significant scope to outperform due to the inefficient nature of the market. This inefficiency is driven by high levels of retail participation, insufficient research coverage, and an over-emphasis on short term trading. Over the last decade, the median active manager has outperformed MSCI China A by 4.7% per annum, a performance that the median manager in the MSCI World universe has struggled to match (see Figure 3).

Figure 3: Median Active Manager Return and Alpha over 10 Years*

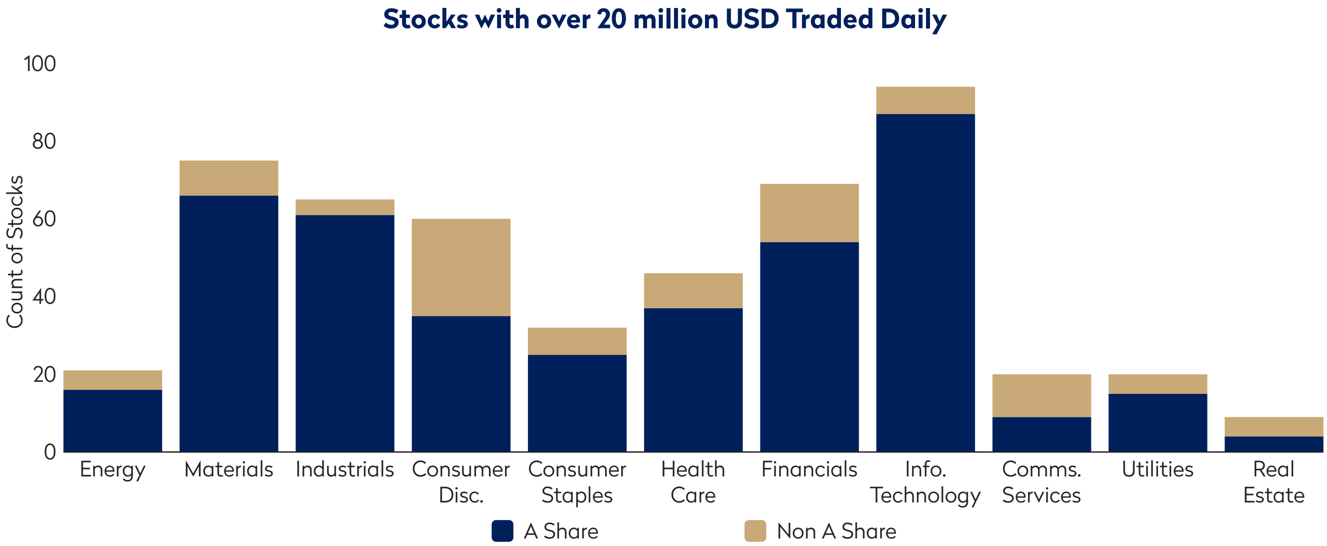


*Data as of June 30, 2024. Source: eVestment

[2]Quote by CSRC Chairman Yi Huiman at a high profile Shanghai conference
[3]Data as of September 30, 2024. Source: FactSet

In a market with over 6000 companies, stock selection opportunities are abundant (see Figure 4), with a breath of liquid opportunities across major sectors only second to the US market.

Figure 4: China A shares are diverse by sectors and have high liquidity



Data as of September 30, 2024. Source: Factset 3M Daily Average Trading Value in USD of MSCI China constituents

The potential for alpha generation appears set to continue. There is evidence that the new economic conditions in China will be a more favourable environment for disciplined value managers. They may be able to avoid the risks associated with the less price sensitive growth investing style which has historically dominated investing in China. Defensive and fundamentally driven value managers are also likely to protect capital in a market that is highly volatile. According to eVestment data, only 10% of China A share managers in their database, are categorised as Value managers. The same data also shows that the median Value manager has outperformed the broad benchmark by 9.7% per annum over the last 3 years, doing significantly better than their Growth and Core peers.[4]

Conclusion

In conclusion, we believe China A-shares offer a compelling proposition for institutional investors. With attractive valuations, low global market correlation and diverse opportunities, A-shares stand out as an attractive alternative strategic allocation for asset allocators.

History suggests that investing during the most pessimistic periods in China's A share market tends to reward investors with high returns in subsequent periods. Notwithstanding the recently announced stimulus, China's slowing economy indicate that the revenue and earnings trajectory are likely to moderate compared to history. We believe an important part of future returns for investors will be via dividends and share buy backs and there is ample opportunity for stock selection through active management. For example, Mondrian's China A share portfolio trades on a P/E of 10x and has a starting dividend yield of 4.0%[5], an attractive portfolio of focused holdings that also provide investors with an income cushion as China continues its economic transition.

[4]Relative to the MSCI A Share benchmark, median Growth and Core managers have performed -8.4% p.a and 0% p.a respectively. Data as of June 30, 2024. Source: eVestment.

[5]Data as of June 30, 2024. Source: Mondrian Investment Partners

Disclosure

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Unless otherwise stated, all returns are in USD

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