Global Asset Management

Commentary: The opportunities and risks of investing in Chinese A shares

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Access for foreign investors to the domestic China stock market started in the early 1990s, with U.S. dollar-denominated B shares, and it increased in 2002 with the introduction of the qualified foreign institutional investor program.

For institutional investors, the big change occurred in November 2014 with the introduction of the Shanghai-Hong Kong Stock Connect, followed in December 2016 by the Shenzhen-Hong Kong Stock Connect. These two connects allow all Hong Kong and overseas investors to trade eligible shares listed in Shanghai and Shenzhen through the Hong Kong Stock Exchange, with no individual buy or sell quotas.

Investors' interest has increased more recently with the inclusion of Hong Kong Connect eligible A shares in the MSCI Emerging Markets and Asia indexes. On June 1, 2018, 233 large-cap A-share stocks were added to the MSCI indexes with an inclusion factor of 2.5%, which was subsequently increased to 5% on Sept. 3. The aggregate weight in the emerging markets index is still small, about 0.9%, but we expect this to increase to about 5% in the next two years as more stocks are added and their inclusion factor increases to 20%. In the long term, their weight could grow to about 20% if midcap stocks become eligible and the inclusion factor is increased to 100%.

For long-term active investors, the attractive opportunities presented by A shares are more important than the benchmark inclusion itself. These shares constitute a large, liquid, but inefficient market, which is ideal for long-term investors that have the resources to conduct in-depth research and meet

these companies in China. The total A-shares market now has a market cap of about $8.5 trillion, only surpassed by the Nasdaq ($11 trillion) and the New York Stock Exchange ($25 trillion).

One attractive attribute of A shares is their higher exposure to non-government-owned companies in consumption-driven industries compared with Hong Kong-listed companies, which historically have been dominated by large state-owned enterprises in the financial and energy sectors. The Shenzhen exchange in particular has a more attractive selection of companies, with about 60% of Shenzhen's market cap in technology, consumer goods and industrials.

This more balanced sector composition also means there is a larger number of small and midsize companies available through the two stock connects than in Hong Kong. This, combined with the less institutional nature of the A-shares market means that sell-side research coverage is less developed and company information is more difficult to come by. UBS Investment Bank has calculated that since 2012, only 43% of A-share companies have reported full-year earnings within 10% of sell-side consensus estimates compared to more than 70% for U.S. companies. This market inefficiency can be viewed positively by teams focused on doing their own independent research.

On the other hand, A shares also present unique risks to investors. Eighty-six percent of trading volume is conducted by retail investors, compared with 35% in Hong Kong. As a result, the market is much more volatile, with the average standard deviation of monthly returns around 11.5% compared with 7% for Hong Kong-listed stocks, according to UBS.

Furthermore, a focus on corporate governance risks is always critical when investing in emerging markets, and this is especially true for A shares. Common corporate governance concerns for Chinese companies include a reliance on government subsidies, the risk of arbitrary government interference, large transactions or M&A activity with related companies, as well as a heightened risk of accounting fraud. While corporate governance risks by their nature can be difficult to quantify, to put this heightened risk into perspective we draw on one of our research partners, GMT Research. According to their accounting risk screening tool, about 1% of global firms demonstrate similar traits to past cash-flow frauds, whereas this number rises to as high as 7% for companies in China.

This underscores the importance of active management with a focus on corporate governance in emerging markets given the large and increasing size of China in the overall asset class. As A shares become a larger proportion of the MSCI Emerging Markets and Asia indexes, passive investors will increasingly be exposed to this market along with its higher volatility and heightened corporate governance risks. Active managers who have the resources to undertake their own on-the-ground research in China, and have a multiyear investment horizon in order to benefit from the lower market efficiency, should be well placed to take advantage of the investment opportunity that A shares represent.

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