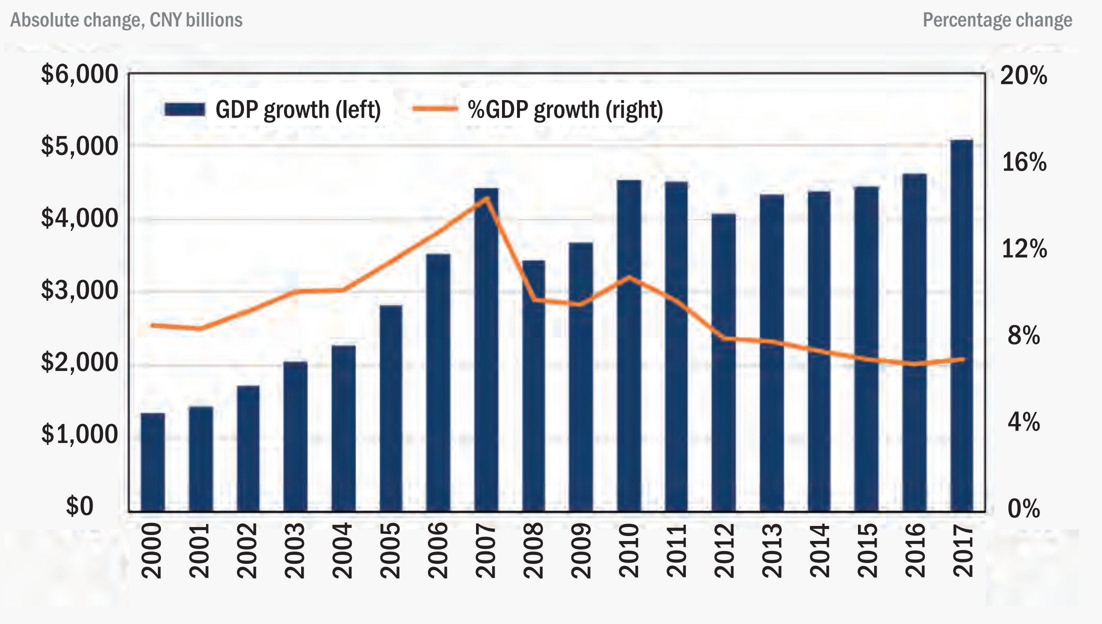
AUGUST 2018

China A-Shares: The “Beta” Story

Over the past 30 years, China has experienced dramatic economic expansion, eclipsing most other emerging market economies and virtually all of the developed countries. As Exhibit 1 illustrates, China’s GDP climbed at an average rate of just over 9% per year since 2000, often breaking into double-digit growth over that period. Currently the second-largest economy in the world, China is expected to pass the U.S. as the number one within 10 years. But how does that extraordinary growth translate into an opportunity for equity investors?

Exhibit 1. China's annual GDP growth over the last two decades

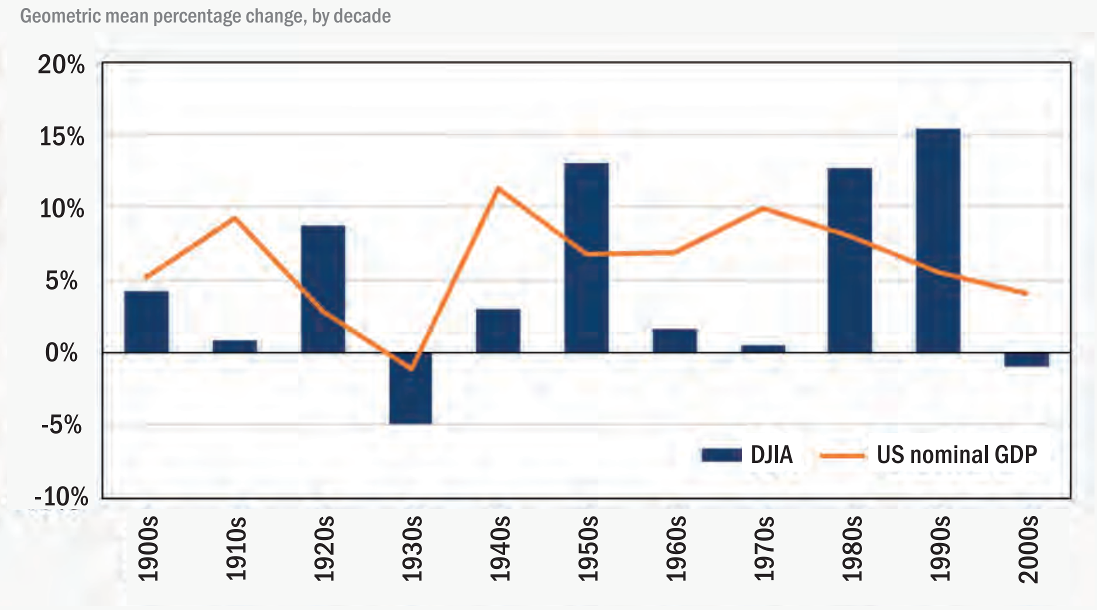


Source: Rayliant Investment Research, World Bank

Economic growth is one determinant

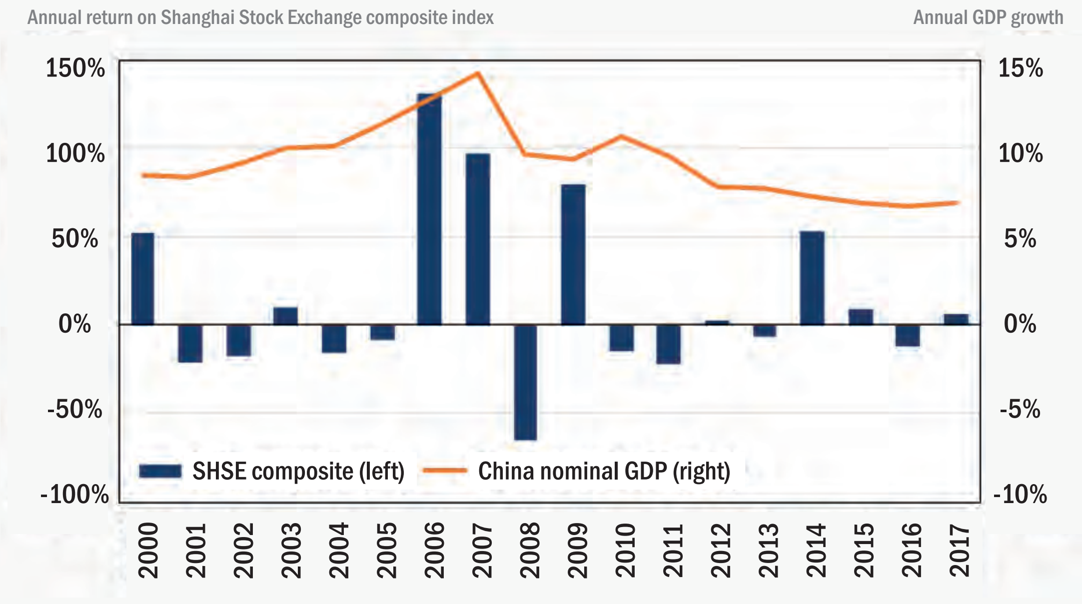
Although China’s economic growth rate is among the highest of large economies, strong economic growth does not always translate to stock market outperformance, as can be seen in Exhibit 2. Likewise, the U.S. saw its strongest decade of economic growth in the past 50 years during the 1970s, a period over which nominal GDP expanded by an average of 10% per year. Nevertheless, we can see in Exhibit 3 that the stock market return during that decade came in at a paltry 5.8% due to rampant inflation. So, while economic growth *helps* to fuel earnings growth, there are likely other factors necessary to foster strong stock returns.

Exhibit 2. U.S. stock market returns haven't correlated perfectly with economic growth



Source: Rayliant Investment Research, Bloomberg, US Federal Reserve, MeasuringWorth.com

Exhibit 3. Despite persistent and rapid economic growth, Chinese stocks have sometimes struggled

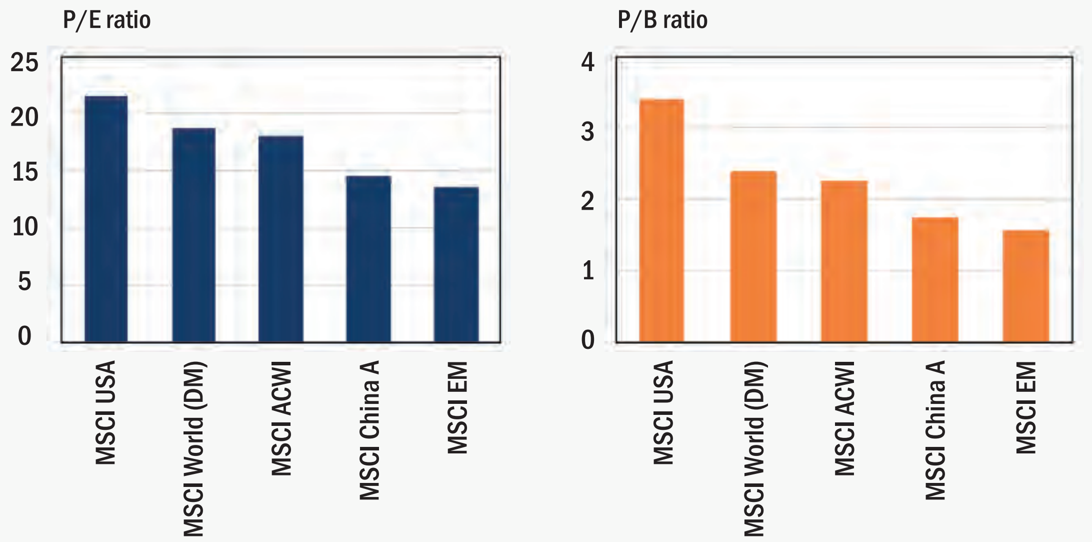


Source: Rayliant Investment Research, Bloomberg, World Bank

Beginning valuations at a discount

At least as early as the 1930s, famed investors Graham and Dodd promoted an intuitive notion that one of the most significant factors in determining a stock’s future return premium is its valuation at the time of investment. This idea has been advanced again in recent decades by finance academics, including Eugene Fama, Kenneth French, and many others. Most often, valuation is defined quite simply as the ratio of an asset’s price to its fundamentals. Take the price-to-book ratio, for example, which answers the question: What is the price that an investor must pay for $1 of book value? For the Chinese stock market, the current price-to-book ratio stands at a comparative discount to most developed markets at 1.9, versus 2.4 for the MSCI World index, or a hefty 3.3 for U.S. equities. When it comes to buying broad exposure to a market in the hope of earning a premium going forward, a relative valuation discount seems like an encouraging start.

Exhibit 4. Valuations in Emerging Markets are currently attractive by comparison to DM and U.S. equities

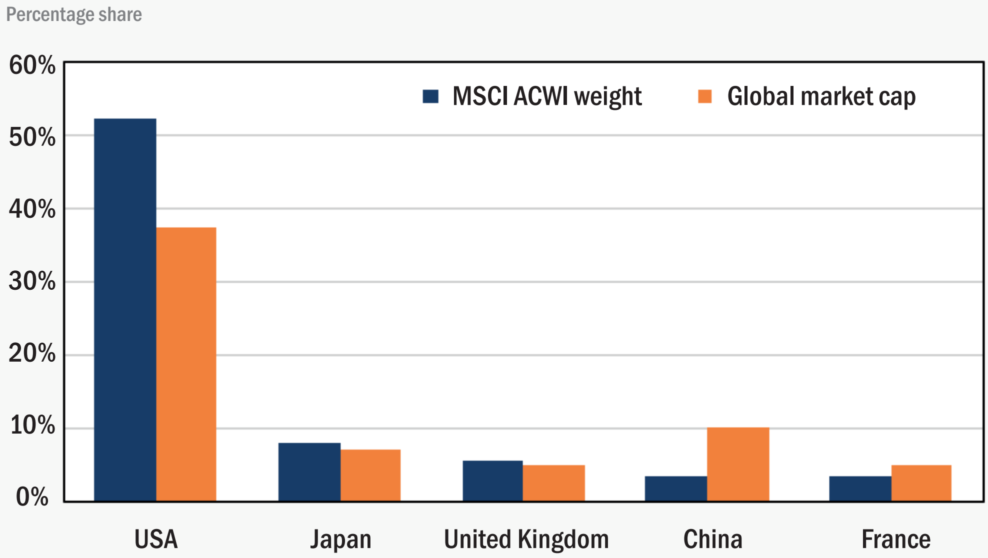


Source: Rayliant Investment Research, MSCI (as of July 2018)

Investment flows could provide a tailwind

Beyond valuations, one might also reasonably ask how demand for Chinese shares might change over time. In 2003, China’s market cap was $420 billion placing it behind smaller economies like Switzerland and Canada in terms of stock market size. By 2017, China’s market cap had grown to $8.7 trillion, passing Japan as the world’s second-largest equity market, and trailing only the U.S. Interestingly, while China represented around 15% of global GDP at the beginning of 2018 and 10% of global market cap, it only constituted 3.7% of the MSCI ACWI portfolio. It stands to reason that as China’s markets grow toward parity in terms of stock market size relative to GDP, equity holders could reap substantial gains.

Exhibit 5. Top country weights in MSCI ACWI as of March 2018 vs. share of global market cap



Source: World Federation of Exchanges December 2017 report

A potential catalyst: The "Great Rebalance"

Starting in June 2018, MSCI began including Chinese A-shares in some of its emerging markets indexes. This inclusion is intended to occur gradually over the next five years, with the allocation to mainland Chinese stocks eventually reaching the country's representative market cap of 16% by 2023. Given that nearly $2.0 trillion in assets track the MSCI EM Index, this rebalancing could serve as a significant demand "shock" to A-shares prices, as hundreds of billions of dollars flow into mainland stocks through passive investment into the broad indexes as they start to include China A-shares for the first time.

Conclusions: A case for adding exposure to Chinese equities

There is little doubt that China will continue to exert a large influence on the global economic stage and a good chance that it soon surpasses the U.S. in terms of the sheer size of its economy. Combining that robust growth with reasonable equity valuations relative to those available in developed markets and a benchmark inclusion event that's likely to draw passive index flows to Chinese equities, the case for an allocation to mainland Chinese stocks is compelling. One thing is certain: Whatever the outcome, the opportunity for Chinese A-shares may be too big to ignore.

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