FIDELITY COMPASS

Investing in China – when and how?

Victoria Mio, Director of Asian Equities

Pamela Ritchie, Host

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Ryan Hendy: Welcome to Fidelity Compass, your source for institutional insights. My name is Ryan Hendy and I'm director of consultant relations at Fidelity Canada Institutional. I'm thrilled to have you join us for a webcast today on the investment opportunity in China. China's equity market is rapidly evolving. In the past five years, the market has been moved from being a retail-led and momentum-driven to a more diverse and professional and domestic investor base with a greater focus on fundamentals with projections suggesting that China may soon emerge as the world's largest national economy.

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Chinese regulators have helped by implementing reforms such as strengthening the rule of law, as well as reforms clarifying responsibilities and accountability among central and subnational governments. This has attracted international investors drawn by the size, diversity and increase in governance standards of the Chinese market. In fact, the 2020 Greenwich Associates report, China on the global stage, shows that institutional investors are investing in Chinese assets and they're doing it largely for diversification and alpha generation. However, how they're getting that exposure is largely through investments in global equity and emerging market funds rather than the direct allocation of Chinese public equities or private markets.

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This approach, while practical for simple allocations, generally limits exposure to large companies whose stocks are available to listed ADRs. It represents a small fraction of the Chinese opportunity set. The report states, however, that asset owners do expect to allocate more in the next three to five years, including dedicated China allocations. With this in mind, we were joined earlier today by Victoria Mio, director of Asian equities at Fidelity International, where she discussed when and how institutional investors can capitalize on the investment opportunity in China. Please enjoy the webcast and have a great day.

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Pamela Ritchie: Hello and welcome to Fidelity Compass, your source for institutional insights. I'm your host, Pamela Ritchie. Victoria, I want to welcome you. Very glad to have you here joining us today. We want to get to the source of—if investing in China—when should we invest in China, how and try to answer some of those questions throughout our conversation today. China, of course, is a huge contributor to the global economy. There've been lots of pieces of this growing for decades now but obviously, China is a massive player here. Certain ways of allocating and getting exposure to China have been through the MSCI Emerging Markets Index. But some institutions certainly have been thinking more and more about getting a more dedicated exposure for China. Can we walk through the evolution in your mind of China's integration into various equity indices? How has that looked over the last several years?

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Victoria Mio: Hi Pamela. I look forward to have an interesting conversation with you on China. This is actually an excellent question to start. Let me give you a context. I was born in rural part of China. When I was a child, I have only one piece of new clothes every year and that was handmade by my mother. But I felt very happy. That was before China's economy took off. Now, after 40 years of breakneck growth, China account for 18% of global GDP but then in terms of its indices in the global equity, it is only 5% of MSCI World or 37% of emerging markets. For some historical reason, only the Chinese offshore market is being included in the global indexes and a lot of global investor follows these indexes and therefore they have very low participation in the Chinese stock market and also has very low allocation in their global portfolio. What I will argue is that with the increase in the importance of the Chinese equity market in a global context, we think that a dedicated China allocation will be an important part or core part of any global portfolio. We think that China Asia market should be a must-have piece in the investor' portfolio.

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Pamela Ritchie: Can I ask Victoria, then, how we get ... because that's a little bit of the why, and when seems to be now, and we might come back to all of those pieces in our conversation today but also the how. I feel like this is a big missing piece as well. There are a number of different types of shares, for instance, and people here have A-shares, the mainland China shares that are available in two different stock exchanges. Then we know that there's the B, the H, and also ADRs, a lot of people are familiar with ADRs, the American Depository Receipts. How do investors, institutional investors, make sure that they get access in the right ways to Chinese equities? What are the options?

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Victoria Mio: Let's use a good or simple analogy. Just like you go to a Chinese restaurant ordering Chinese dim sum, you'll see a whole range of dishes that you can choose. Chinese stock market's like that. We have A, B and then H and ADR, all these selections. A simple ways to dissect them is to divide them into onshore or offshore, because there's different ways to get access. For the onshore market, it is the A-shares and B-shares that being listed in Shanghai or Shenzhen. The offshore markets are those that are listed in Hong Kong or in the U.S. called ADR. These are H-shares for Hong Kong listed and ADRs for the U.S. listed. They have very different market conditions and access methods.

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Traditionally, investors can access to the H-shares or the offshore market very easily. You'll just open an account or invest it in the Hong Kong Stock Exchange or the U.S. But since 2018, China and Hong Kong introduced what we call Stock Connect. Basically is a scheme that allows investors from the offshore market or foreign investor to get access to onshore market through Hong Kong Stock Exchange and where those domestic China investor to get access to the H-share through the respective market. This is a very easy channel. Because of that, it allows foreign investors to get access to more than a 1,500 Asia stock easily. It became an important place for investors to discover ultimately a lot of alpha opportunity that has not been open to foreign investor in the past.

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I would suggest investors that are considering to invest in China market really look into not only the traditional ADRs that you've seen or Hong Kong stock, but the Asia through the Stock Connect. It's a dedicated China strategy should have encompassed both onshore and offshore market based on the opportunities that brought them where they're located.

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Pamela Ritchie: It's so interesting because there have been many policy shifts to help the market and investors really go through a maturing process. This happens all the time. How have some of these different options and areas where... I shouldn't say options, meaning as a financial product, but I mean, there's a variety of different ways to invest more directly in China. How has policy come along to help that evolve, to help that become easier? Maybe we'll talk about what investors are wanting also in a more mature and wanting to understand how to invest and where quality lies. But first of all, let's go to the policy itself. How has aspects of policy made it easier and more streamlined to invest in Chinese equities?

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Victoria Mio: Traditionally, the onshore market is not open to foreign investor and investors need to apply for QFII or RQFII. These are your qualified foreign institutional investor licence. In order to attract more investors to invest into the domestic market, China government undergone a range of reforms, what we call financial market reform, that improve access, improve the governance of the companies, improve regulatory environment, and also provide easier channel for foreign investors to get access. Since 2018, when this Stock Connect scheme being introduced, it is really a big coupe for a global investor because it creates a channel for growth investor to get access to the onshore market in a seamless way, just as if they are investing in the H-share in the offshore market in the same way.

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This is a scheme that allows for very easy cross-border investment. We expect that right now with this Stock Connect being introduced, global indexes now has included A-shares into the index, but it's still with a 20%, say, inclusion factor for MSCI. So that is lower than its potential. We expect that as government continues to introduce more reform, this inclusion factor will gradually increase. So for investor who wants to have that access, actually, now is the time because there will be more and more investors getting into the market and with increased inflows, it will also provide not only the assertions that this is a market that is investable, but also discovers some of the gems in the local market. So the early investor are the ones who can gain the advantage to invest in these gems earlier than others.

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Pamela Ritchie: So switching a strategy from being invested in a broader EM MSCI index investing, which doesn't, as you say, have an enormous amount of exposure to China directly, and switching to something where you can get more direct now before it becomes popular through the indice options and so on. It's a very interesting time, as you say. We were talking about ADRs. There have been political rumblings about ADRs and that's sort of a separate story, but is it just easier to go through the Stock Connect side of things rather than ADRs? What's the relationship there?

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Victoria Mio: First of all, we need to look at the opportunities that are available in each market. What we notice is in terms of sector exposure, Asia has almost all the sector available and particularly strong in the area, such as consumer, industrials, and also health care. These are where the high-growth opportunities and alpha opportunities are, and they are in the onshore market. For the offshore market in Hong Kong, we will also have a lot of traditional banking or consumer names. In the ADR, you can gain access to a lot of internet, high-growth, high-volatility stocks.

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For an institutional investor who wants to gain access, the best way is through a dedicated China fund structure where it can have access to both ADRs, both the onshore and offshore market, so that it is a complete program or a complete portfolio, well-balanced with all the different available opportunity. To do that, it requires more on-the-ground resources located in Shanghai or in China and also some on-the-ground knowledge in Hong Kong. Therefore, to deal with such a complex and big market like China, it requires two things. One is a dedicated vehicle that can have access to multiple share classes. Second is go with investor that has local deep knowledge and investors on the ground.

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Pamela Ritchie: Let's get further into some of that. There's also the discussion, and you've mentioned this, newer economy, older economy, there's a restructuring going on, I would say, around the world. But particularly, how does this affect how investors make decisions right now? There's a little bit of a separation and there's probably opportunities in both. Can you discuss that, the restructuring of new economy, old economy?

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Victoria Mio: This is the big issues or the big change that we notice in China and it affects how we invest going forward. If you go back 10 years ago when the whole world went into the global financial crisis, China immediately started a new round of economic stimulus and that boost, what we call the old or traditional economy, and that is domestic infrastructure spending and then boosting the manufacturing sectors to export. But after a few years of this kind of growth, we have built enough roads and bridges. In terms of export, we are one of the largest exporters in the world. This growth started to slow down. Fortunately, China government as well as entrepreneurs realizing the growth potential is somewhere else, and that is the domestic demand which come from the consumer, other companies and also the government. So that is what we called the new economy.

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What we've seen in the past few years is that there are several areas of the new economy exploded. One is the internet sector or the technology sector, and you can gain exposure through the ADR. Another one is the consumer sector. We go from buying all kinds of goods to now services to now your premiumization. Another area of great growth is health care space. With the ageing of the population in China and the increase in income, there are also more money pour into the health care sector. We expect that these areas will continue to offer structural growth opportunity for global investors to invest and gain a piece of the growth pie.

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Pamela Ritchie: It's fascinating. As you mentioned, there's the consumer, there's local and then that premiumization. I wonder if we can just go into that a little bit further. Obviously, investors who are looking more and more for quality, which I know is happening, and you can tell us about that, but that premiumization of what's available within the local market. It's a shift, isn't it, within the consumer?

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Victoria Mio: Yeah. Think of it this way: when the income level increased from $1,000 USD per year to now $10,000, as people see their income increase, they will gradually shift their buying basket from buying the low quality ones to the high quality. We can see that in, say, for example, the clothings, the cars that they bought and also the food. Let's take a look at, say, for example, sportswear. It used to be that they will buy very cheap sportswear. Now, gradually they're buying your international brand as well as local brands that demonstrate very high quality. In terms of the luxury product, we have seen tremendous growth in luxury product, not only inside China, but globally. A lot of the luxury products seeing demand from these China investor.

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In the auto space it used to be that they will buy a lot of local brands, but then international brands that has [indecipherable] in China also actually offer one of the biggest growth potential. In addition to this kind of product premiumization, we are also seeing in terms of the services. One good example is in terms of travel, in terms of tourism, they used to just travel inside China. Now, before the pandemic actually, they travel everywhere and go to high-end, very fancy restaurant. So these are what we call premiumization.

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Pamela Ritchie: It's so interesting. Let's move a little bit, there's a lot of discussion, as you know, globally about a shift from growth to value and people have different views on that and how that works. Then within the so-called value area, it's sort of a shift to quality. Again, lots of opinions within there about what's the best place to be. But can you talk about a growing demand for quality and what that means in terms of either sectors or companies and really the research required to make sure that investments are in that so-called "quality" area?

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Victoria Mio: That's is actually a very fascinating phenomena that's happening inside the domestic China market. It used to be that the Chinese market, or it is still dominated by retail investor. As such there are different biases. For example, they have this short-term orientation. They chase the very hot sectors or themes at the moment without looking into fundamental. The institutional investor knows that in discount market it is highly inefficient. To benefit from the inefficiency, investor can do deeper on the mental research. What has happened is in the last two years, since foreign investor can gain access to the China market and introduce this focus on fundamental and high quality, it signals to the markets that these are the good names to invest. And then domestic investors also chase after the stocks that foreign investor bought and continue to do so.

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As such, we're seeing an interesting trend that the retail investor now knowing that they cannot have an edge over institutional investor, they are buying into the funds or institutional funds in China. With the increase in institutional participation from foreign investor and also domestic local mutual funds, there's a trend towards institutionalization of the market. There has been an increasing focus on fundamental, stock that has higher quality, such as higher ROE, higher earnings growth, lower volatility tend to perform against the smaller stocks that are of low quality. I think this plays really well on the hands of the institutional investor who has deep knowledge.

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Pamela Ritchie: It's fascinating and just to extend that general area and discussion, to what extent are so-called quality companies or companies that you're doing fundamental research on and you arrive at a conclusion, to what extent are those companies SOEs or state-owned enterprises or partially state-owned enterprises? Explain to us because there's also a shift going on there as well, right?

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Victoria Mio: Yeah. It's interesting that in China they're actually, in the whole stock market, it used to be more than 60% to 70% of the entire universe, what we call state-owned companies. They are largely in sectors that are dominated by the state-owned companies such as financials, oil and gas, very capital-intensive sector. They have very prominent positions in the market during the time when old economy stock are the one that dominates the market, because when the economy focuses on fixed assets investment and manufacturing sector. But gone are the time when these companies are the major force in the economy. As I mentioned, there's a shift towards the private or the shift towards the new economy. The characteristic of the new economy is that because it's new, it requires entrepreneurial spirit. It requires taking risks and they require innovation.

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During the past 10 years, what we've seen is that with the growth in the economy, more and more individuals start to start their own business to capitalize on this growth. Gradually they become big, they become very successful and listed in the market. So we are noticing a gradual decrease in the percentage of the state-owned sector and then an increase in the entrepreneurial sector. I think now the percentage just reverse. Probably only 40% or so that are state owned and he rest are more entrepreneurial. We think that because of the differences in the incentives system and also the management and leadership and the sector they are in, we have a preference to invest more in the new economy sector that are not dominated by state-owned companies.

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Pamela Ritchie: The passive allocation that either index funds or perhaps just a broader way of investing, it probably would not catch some of those subtleties of transition, of evolution. Is that fair?

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Victoria Mio: Exactly, exactly. Actually, actively managed fund has outperformed the ETF in many different markets in China, both onshore and offshore and also in different segments. One of the major reasons, as I mentioned earlier, is that China market is still dominated by retail investor. It used to be 80 to 90% of the transaction volume is driven by retail investor. Now may be down to about 60 to 70%, but it is still dominated by the retail investor. This kind of market environment will breed inefficiency and create alpha opportunity. It really presents a compelling opportunity for institutional investor to use active manager to gain access to this market.

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Pamela Ritchie: We talk about ESG all the time, don't we? It's mentioned in global meetings. It's mentioned all over the place and every country and company is trying to figure out what they need to be doing. My question broadly to you is, to what extent are companies both in Hong Kong but also in mainland China, thinking about this? What aspects of the E and the S and the G are useful to think about when investing in Chinese equity markets?

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Victoria Mio: Yes, that's very good questions. In terms of ESG we all know that China is generally very far behind and this is undeniable. What I would like to point out is that it is catching up fast. In fact, in 2020, maybe it would present one of the inflection year where ESG investing become in the mainstream in front of the investor and some of the domestic China ESG fund actually outperform the general market.

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Pamela Ritchie: Interesting. Really. So we take the pieces, the E, the S and the G. The G, the governance, there's an inextricable link to obviously the fundamental research that you've been talking about that is getting better and better and better and stands to continue to improve. That's, I guess, one piece. On the environmental side, we know broadly there's some goals that have been committed to by China, can you outline those? And I guess how they filter down to what companies are thinking about?

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Victoria Mio: Great. Glad that you pointed this out. Last year in September, President Xi of China announced that China will achieve carbon peak in 2030 and carbon neutrality in 2060. And since then, many companies, not only state-owned companies, but also some of the large companies have been following the government's guidelines, published their goals to help implement these policy and also follow the general directions. So it presents a substantial opportunity for ESG or sustainable investor to pick companies who will align with these goals of the government and whether they take actions. The process of decarbonization in the entire economy will produce winners and losers. Winners are those that are already in the green sectors, for example, EV, solar, wind and also natural gas, et cetera. These are natural green sectors that investors can access.

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But those that are maybe in less green or even in the polluted sector, they can still do something about it, and that is transform their companies towards green. For example, some of the independent power producers that traditionally use coal fire has now embarked on a road to transform their composition. These kind of companies can be also considered in the ESG fund. Moreover, what we are seeing is that regulators are also making some changes. It is making policy in four directions. One is it is going to require disclosure. It used to be voluntary disclosure in ESG, in the future it's going to be mandatory and then it is also going to be aligned with international standards. The emphasis is not only in E that I mentioned, but also in S and G, so a comprehensive ESG disclosure framework. I will say that the environment starts to stepping up for ESG investor to find investment opportunity for the long term.

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Pamela Ritchie: Now, the other thing that's long term looking forward, not backwards, there has been a change, obviously, in the geopolitical. There's still issues, no question but is there overall a softening? There's a new administration in the United States. Is there overall a softening, a willingness to discuss? Do you find that?

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Victoria Mio: Yes. What we believe is that it is going to stay a comparative conversations for the long term, but recently we are seeing the conversation between the U.S. Biden administration and President Xi. Internally, what we're seeing is that China thinking about changing the way that they interact with the U.S. and also how they interact with the world. So we see on both sides there's a softening of the stand. Instead, it is willing and able and also wants to come back to the negotiation table and differentiate the places where they have huge disagreement and then cooperate on areas where they can have a common goal. For example, climate change is one area where both sides have a stake in it and wants to cooperate.

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Pamela Ritchie: Victoria Mio, it has been a great pleasure speaking with you. Thank you for your time. Thank you for your insights. I hope you have a great day.

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Victoria Mio: Thank you.

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Pamela Ritchie: Thank you to everyone joining us today, tuning in as well, and as always, if you have suggestions on future topics or guests that you'd like to see here on Fidelity Compass, we'd certainly like you to send in your feedback to us.

In the meantime, stay tuned for more on the Fidelity Compass webcast side of things. Thanks for joining us. I'm Pamela Ritchie.