RECONCILING THE CHINESE ECONOMY WITH CHINESE EQUITIES

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While many investors understand the important role that China plays in the global economy, this generally doesn't translate into significant portions in their equity portfolios. In our view, this will likely change over the course of the next several years. After a series of financial market reforms, President Xi Jinping could be on track to oversee the most significant shift in Chinese policy since Deng Xiaoping. However, getting exposure to Chinese stocks today is not necessarily as straightforward as in the U.S. market. American companies list on U.S. exchanges, while Chinese companies may list in the U.S., Singapore, Hong Kong or mainland China. As a result, the common notion of beta for the Chinese market is ill defined. In this piece we provide an introduction to the variety of options available to investors who seek exposure to Chinese stocks and how the market may evolve over time.

In the table below, we highlight the key differences between the seven varieties of Chinese shares. Until recently, shares listed on mainland China exchanges were generally available only to institutional investors. After a series of pilot programs, global investors are starting to take note. Although MSCI's June 2017 A-shares announcement captured attention, we estimate that the immediate impact on the market will be limited. However, Goldman Sachs released a note proclaiming that A-shares had moved from a nice-to-have market to an essential one. As global access to Chinese markets evolve, subjective decisions for indexes can have a dramatic impact on the breadth of exposure as well as portfolio risk.

Overview of Chinese Share Classes

Exchange Location	Share Class	Description	Trading FX	Largest Sector	Companies
Mainland China	A-Shares	China securities incorporated in mainland china, listed on the Shanghai or Shenzhen Stock Exchange and traded in yuan (CNY)	CNY	Financials	Kweichow Moutai, Ping An Insurance, China Merchants Bank
	B-Shares	China securities incorporated in mainland china, listed on the Shanghai Stock Exchange (USD) and Shenzhen Stock Exchange (HKD)	USD/HKD	Industrials	Shanghai Lujiazui Fin & Trade Dev, Inner Mongolia Yitai Coal, Chongqing Changan Automobile
International	H-Shares	China securities incorporated in mainland china, listed on the Hong Kong Stock Exchange (HKD)	HKD	Financials	China Construction Bank, ICBC, Ping An Insurance
	Red Chips	China securities of state-owned companies incorporated outside mainland china, listed on the Hong Kong Stock Exchange (HKD)	HKD	Telecom. Services	China Mobile, CNOOC, BOC Hong Kong
	P-Chips	China securities of non-government-owned companies incorporated outside mainland china, listed on the Hong Kong Stock Exchange (HKD)	HKD	Consumer Discretionary	Tencent, Geely Automobile, China Evergrande
	N-Shares	China securities (including ADRs) incorporated outside Greater China (mainland China, Hong Kong, Macao and Taiwan), listed on the NYSE Euronext-New York, NASDAQ, NYSE AMEX (N-Shares) traded on USD, and Singapore (S-Shares) Exchanges traded on Singapore dollars (SGD)	USD	Information Technology	Alibaba, Baidu, JD.com
	S-Shares		SGD	Industrials	Yangzijiang Shipbuilding Holdings, Yanlord Land Group, SIIC Environmental

Source: WisdomTree, as of 12/31/17.

The primary rationale for why investors are excited about the A-shares market is that it's underowned in global portfolios, it's largely held by Chinese retail investors and it provides exposure to certain "New China" sectors of the economy that investors lack. In the middle of 2017, Goldman Sachs estimated that approximately 1.4% of the China A-share market was held by foreign investors. This signals opportunity for returns and diversification. On the final point, the economic model in China must evolve, which means increasing exposure to consumer-oriented sectors. The promise of A-shares is that they can dramatically increase opportunities in many of these industries.

International Exposures

For most China investors, H shares are probably the most familiar flavor given that they currently account for 35% of the MSCI China Index.[1] While Hong Kong historically has served as the nexus to mainland China, its role as financial hub ensures that it will continue to be a big part of Chinese allocations. The one challenge is that this segment of the market is dominated by the Financials sector (70%). While Financials can certainly thrive as markets liberalize, they are also viewed with the greatest skepticism from China bears.

In terms of Chinese red chips vs. P chips, we find that significant state ownership may not always convey advantages for shareholders in the long run. However, state-owned firms make up a large percentage of the Chinese economy and should thus be a part of any beta-focused index. Finally, N shares and S shares, dominated by technology firms, represent some of the most dynamic and compelling opportunities in Chinese markets today. While some investors are cautious about Alibaba's and Tencent's massive returns in 2017, we find that a significant portion of their performance has come from dramatic revenue and profit growth as opposed to multiple expansions.

Tying It All Together

In sum, we believe that financial market reform in China will prove to be a positive catalyst for emerging markets generally and China specifically. As access grows, the prominence of China will continue to increase in emerging market indexes as well as global investor portfolios. While some benchmarks currently provide exposure to most flavors of Chinese equities, very few provide complete coverage. This is why we sought to partner with S&P to license the S&P China 500 Index. While it provides exposure to all flavors of Chinese equities, it also seeks to maintain broad-based exposure across sectors. In our view, if investors are interested in overweighting China relative to existing benchmarks, we believe this comprehensive approach offers one of the best approaches to owning beta in Chinese equities.

[1]Source: MSCI, as of 11/30/17.

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Investments focused in China increase the impact of events and developments associated with the region, which can adversely affect performance.

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DEFINITIONS

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

A-share : shares traded on the Shanghai and Shenzhen stock exchanges. This is contrast to Renminbi B shares which are owned by foreigners who cannot purchase A-shares due to Chinese government restrictions.

H-Share : A share of a company incorporated in the Chinese mainland that is listed on the Hong Kong Stock Exchange or other foreign exchange.

MSCI China Index : A free float-adjusted, market capitalization-weighted equity index designed to measure the performance of the Chinese equity market.

Bear market : A sustained downturn in market prices, increasing the chances of negative portfolio returns.

Red chip : Chinese securities of state-owned companies incorporated outside mainland China, listed on the Hong Kong Stock Exchange traded in Hong Kong dollars (HKD).

P Chips : China securities of non-government owned companies incorporated outside Mainland China, listed on the Hong Kong Stock Exchange (HKD).

N-Shares : Chinese securities (including ADRs) incorporated outside Greater China (mainland China, Hong Kong, Macao and Taiwan), listed on the NYSE Euronext-New York, NASDAQ, and NYSE AMEX traded in U.S. dollar (USD).

S shares : Chinese securities (including ADRs) incorporated outside Greater China (mainland China, Hong Kong, Macao and Taiwan), listed on the Singapore Stock Exchange, traded in Singapore dollars (SGD).

S&P China 500 Index : Comprises 500 of the largest, most liquid Chinese companies while approximating the sector composition of the broader Chinese equity market. All Chinese share classes including A-shares and offshore listings are eligible for inclusion.