Mercer

welcome to brighter

Positioning your portfolio for the future of emerging markets

The case for a dedicated China equity allocation

At a glance

We believe that emerging markets should be a core allocation in a well-balanced equity portfolio.

China's rapidly diversifying and increasingly consumption-led economy is **significantly underrepresented** in both standard indices and many investors' equity portfolios, including those with a broad allocation to emerging markets. Headline exposure to China in emerging market equity indices is, for historical reasons, heavily tilted toward its offshore equities, which are primarily listed in Hong Kong and the US.

This overlooks the likelihood that the future dynamics of China's economy will be increasingly reflected in its onshore equity market, which is often referred to as China A-shares. Consequently, for investors to get broad and balanced exposure to China's full opportunity set, both onshore and offshore equities must be represented in their equity portfolios.

Although higher economic growth is often touted as the primary reason for allocating to China's onshore markets, this should just be seen as an additional potential benefit. The real attraction of China's onshore market stems from the enhancements a standalone allocation can make to an overall equity portfolio, due to its **low correlation** with other equity markets and the **abundance of alpha** opportunities.

In addition to a broad emerging markets allocation that includes China offshore equities, Mercer advocates a meaningful **strategic allocation to China's onshore** market, which could represent **5%-10% of an overall equity portfolio**. This exposure can be gained through either specialist **China onshore (A-share)** or **All China equity mandates**. The alpha potential within the China onshore market is significant, but there are also specific ESG and geopolitical risks. Consequently, Mercer **recommends the use of active management** to mitigate these risks when accessing Chinese equities.

The case for emerging markets in general

Our case for investing in emerging market equities is predicated on the diversification of long-term return drivers and the potential for higher returns. Emerging markets (EMs) — which are typically classified as less developed but faster growing economies by index providers[1] — already represent a considerable share of global GDP, and this is expected to increase further in the decades to come. EMs represent approximately 12% of the MSCI All Country World Index (ACWI)[2] as at December 31, 2020, but we recommend higher strategic allocations to EM equities, given the breadth, the associated diversification benefits and potential for higher long-term returns they provide.[3]

We expect higher long-term returns from EM equities primarily due to higher risk. We prefer actively managed EM allocations and expect returns to be further underpinned by higher alpha (compared to developed markets), given the typical inefficiencies across many emerging equity markets.

We believe that equity portfolios should have a strategic allocation to EM of at least market weight, but preferably up to 25% of the equity allocation, with any overweight driven largely by China exposure. In this paper, we outline why investors should have a meaningful dedicated allocation to China.

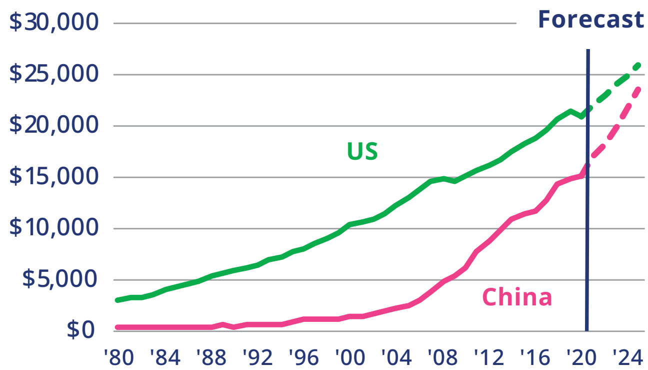
The rise and rise of China

China has outgrown most major economies over the past couple of decades and is expected to continue to do so for some time. Since 2000, China has tripled its share in global GDP and overtaken Japan as the second largest economy in nominal GDP terms. It now drives a significant portion of global GDP growth. The rise of China over the coming decades could underpin unique economic and corporate growth drivers that we believe investors should have exposure to in equity portfolios.

In the last 10 years, China has transitioned from exports, infrastructure and business investment to more balanced growth that is less reliant on trade and more focused on consumption and services. China's Five-Year Plan for 2021-2025 explicitly focuses on productivity-enhancing investments that should lead to higher incomes. These investments also support consumption and higher value-added sectors such as tourism, entertainment, healthcare, industrial automation, renewable energy, biotech and software.

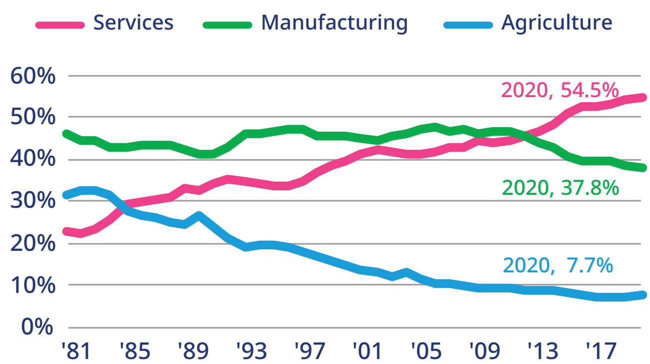
Figure 1. China's economic trajectory

GDP size of China and US



Source: IMF. GDP size, billions, current prices, US dollars. As at December 31, 2020.

Share of Chinese GDP by sector



Source: Bloomberg. Percentage of nominal GDP. As at December 31, 2020.

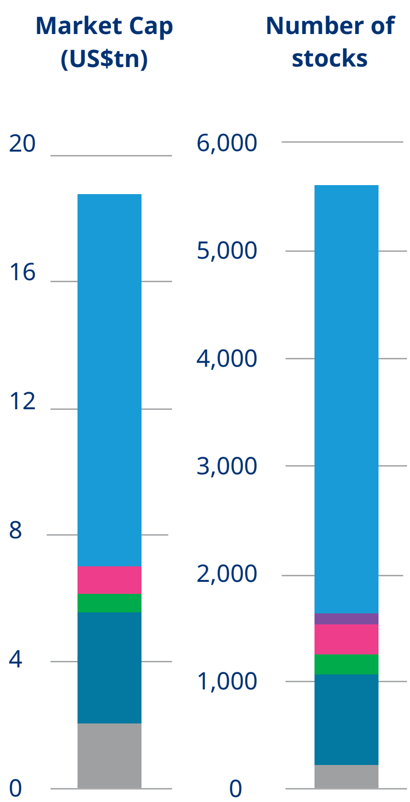
China’s dim sum equity market

Like a dim sum feast with a large range of dishes, Chinese equities come in many forms, as detailed in Figure 2, but they can be grouped into onshore and offshore markets.

The offshore market is primarily composed of shares listed in Hong Kong and the US, and it is easily accessible to global investors. The onshore market is primarily composed of China A-shares, listed in Shanghai and Shenzhen, which have become much more accessible to foreign investors. The Shanghai/Shenzhen — Hong Kong Stock Connect, launched in 2014, as well as the Qualified Foreign Institutional Investor (QFII) and RMB Qualified Foreign Institutional Investor (RQFII) schemes[4] are among those to have facilitated greater access to China A-shares for foreign investors.

Figure 2. Overview of Chinese equity share classes

		Incorporated in mainland China?	Listed on exchange?	Currency
Onshore	A shares	Y	Shanghai/ Shenzhen	RMB
	B shares	Y	Shanghai/ Shenzhen	HKD/USD
Offshore	H shares	Y	Hong Kong	HKD
	Red chips	N	Hong Kong	HKD
	P chips	N	Hong Kong	HKD
	N shares	N	New York	USD



Source: FSSA Investment Managers, Hong Kong Exchanges and Clearing, NASDAQ, as at December 31, 2020.

The A-share market is increasingly important for broad access to China's economic and corporate growth. As shown above, China's onshore market is considerably larger than the offshore market, both by market cap and by number of stocks.[5] The A-share market is also more diverse and tilted more evenly across areas of future domestic consumption (Figure 3). It also provides access to economic segments not well represented offshore, such as leisure, food and beverages, media, and areas of technology.

Finally, Figure 4 illustrates the A-share market's more balanced exposure across market capitalization size bands as the offshore-heavy China exposure within the MSCI EM index is dominated by mega caps. Although the offshore market provides important exposure to China, it is concentrated in a few sectors and stocks.[6]

As China's onshore capital markets develop and mature, we expect them to be increasingly important venues for new listings, which should strengthen the strategic relevance of A-share exposure over time. The launch of the Shanghai Stock Exchange Science and Technology Innovation Board in 2019, alongside the ChiNext market, contribute to a more vibrant listing environment for innovative, fast-growing companies.

With China's policy agenda increasingly focused on domestic consumption, innovation and high value-added segments, such as tech and healthcare, we believe that critical economic and corporate growth exposures may only be fully accessible via the A-share market. Therefore, we advocate a broad and representative allocation to China that incorporates both onshore and offshore exposure.

Figure 3. Sector composition of China A-shares vs. China exposure in MSCI EM Index

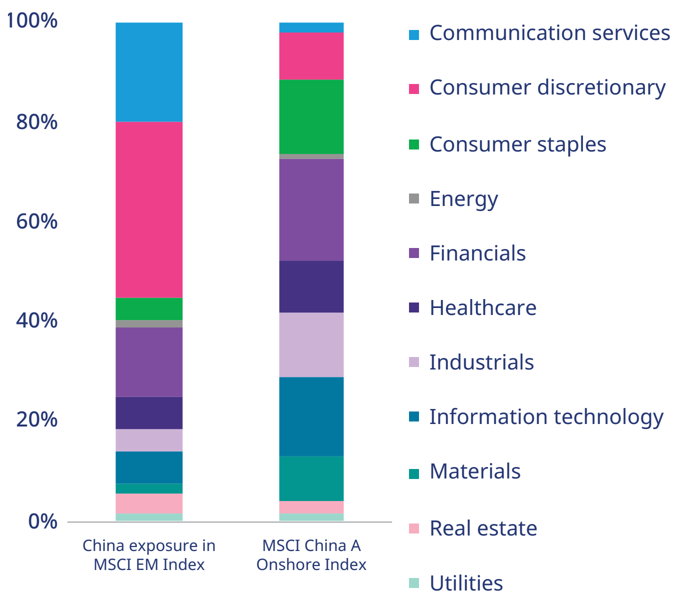
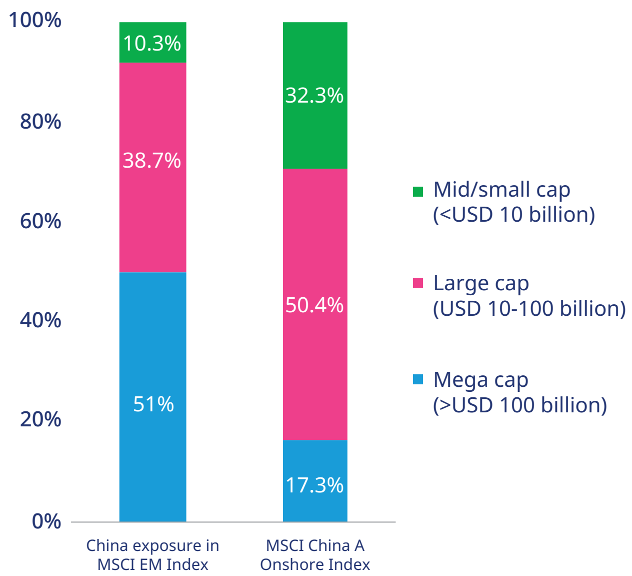


Figure 4. Market cap composition of China A-shares vs. China exposure in MSCI EM Index

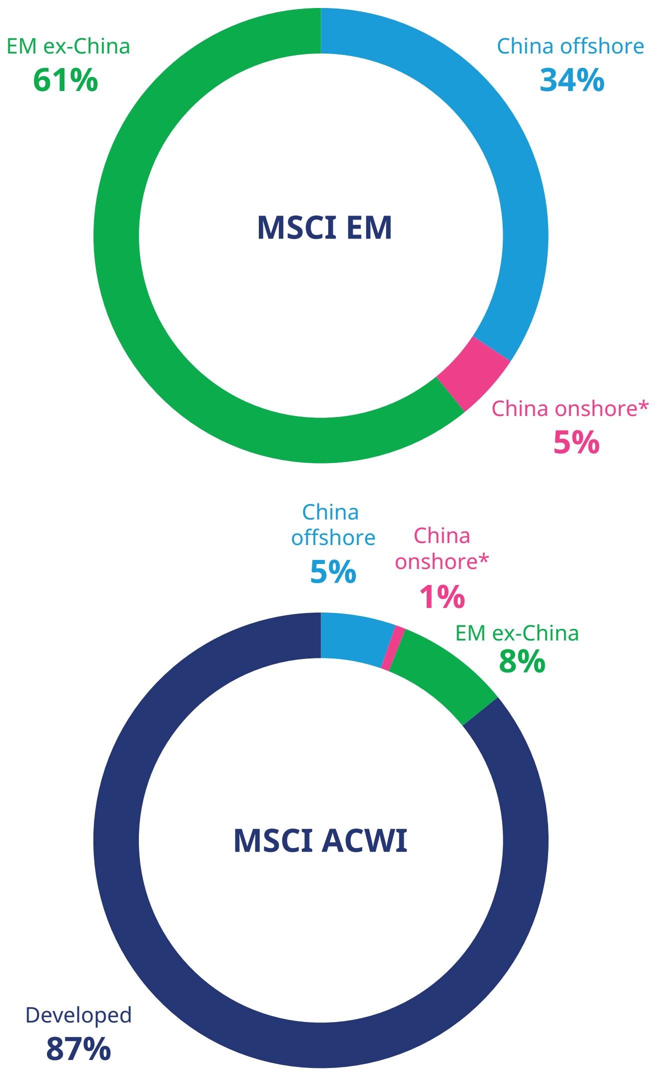


Source: Thomson Reuters Datastream, Mercer Analysis. As at December 31, 2020.

China's simultaneous dominance of, and underrepresentation in, equity indices

Today, most investors obtain public equity exposure to China via global/EM mandates, both directly through China equity exposure and indirectly via China revenues earned by multinational companies in developed and other EMs. The direct exposure to China in the MSCI EM Index is substantial at approximately 40% of the index as at the end of December 2020, as seen in Figure 5. Remarkably, this has increased from less than 5% at the turn of the millennium, as shown in Figure 6.

Figure 5. MSCI EM Index and ACWI in December 2020

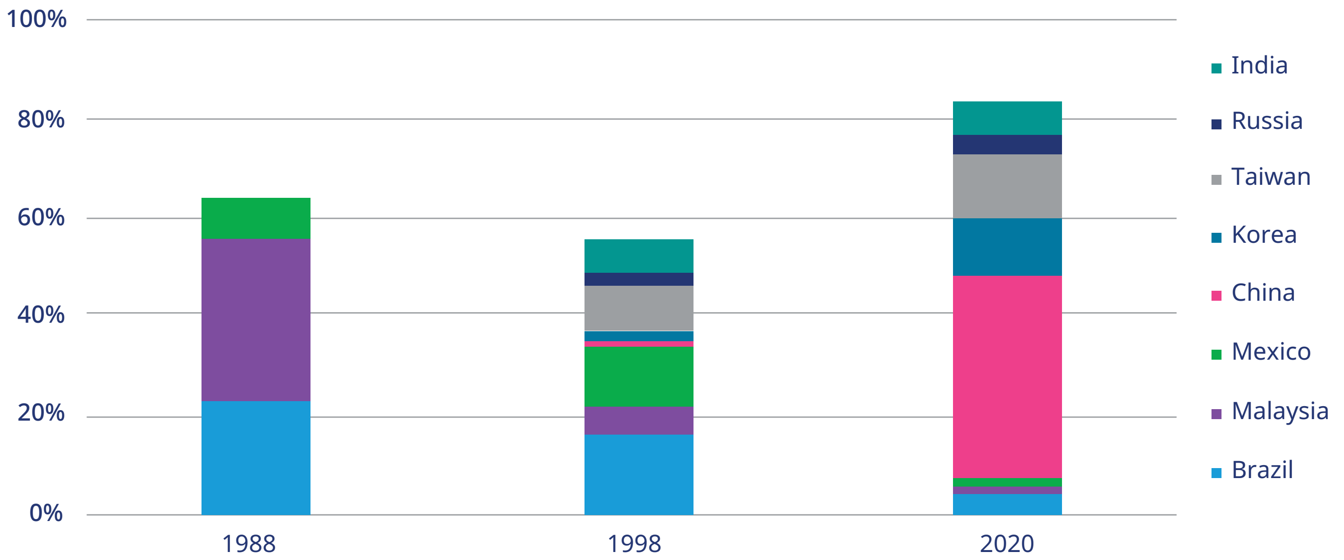


Source: MSCI. December 31, 2020. Index weights have been rounded, so may not add to 100.

*China A-shares constitute the majority (>99%) of China's onshore equity market

Despite China's high representation in EM indices, this exposure is heavily tilted toward the offshore market, while the onshore market is significantly underrepresented. This limits the access to China's economic and corporate growth drivers and may represent an opportunity cost in terms of potential portfolio efficiency.

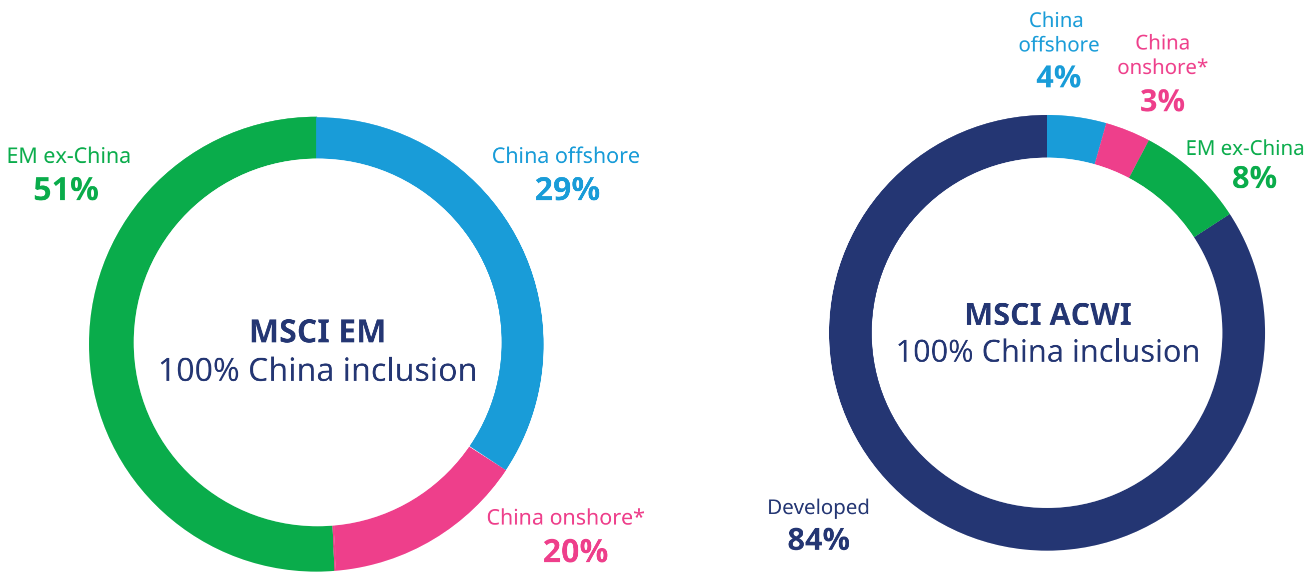
Figure 6. MSCI EM Index weights of selected countries over time



Source: MSCI, Mercer analysis. As of June 30, 1988, June 30, 1998 and December 31, 2020.

As detailed in Figure 7 below, we expect A-share exposures to increase as index providers like MSCI raise the inclusion factor for them towards full inclusion, but the timeline for this transition is uncertain.[7]

Figure 7. MSCI EM and ACWI Index if A-shares were fully included



Source: MSCI, 31 December 2020. Index weights have been rounded, so may not add to 100.

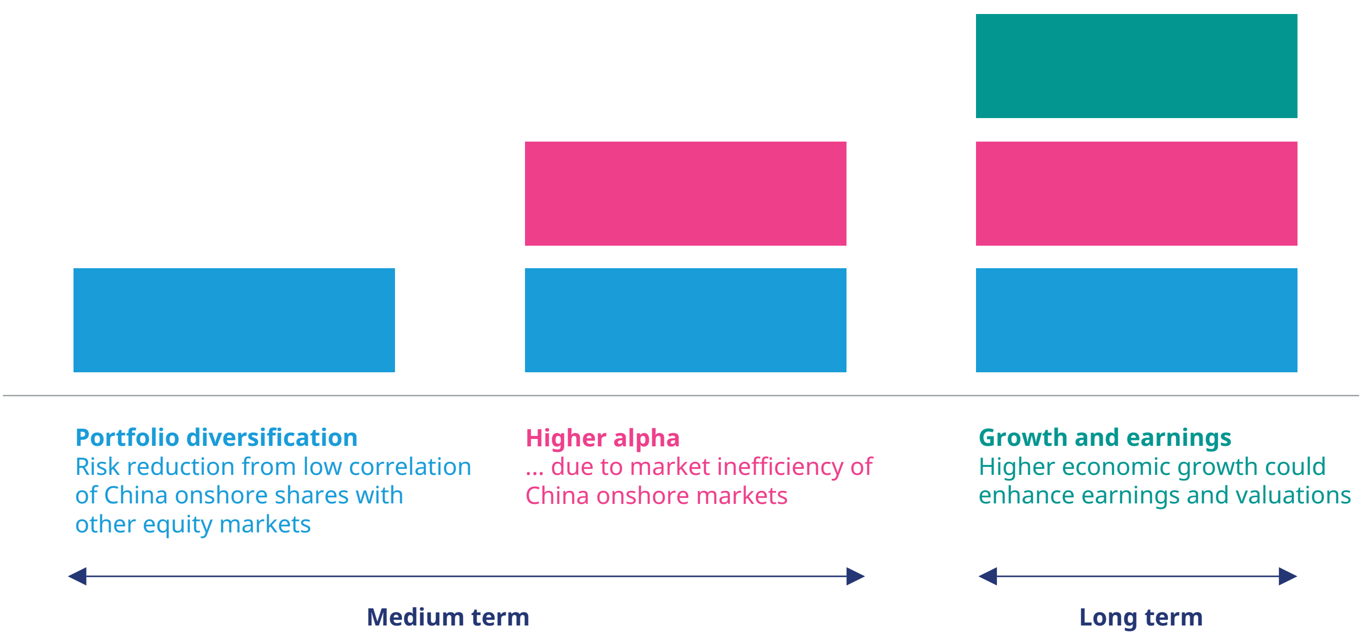
*China A-shares constitute the majority (>99%) of China's onshore equity market.

Market accessibility and other factors hold back higher inclusion of A-shares, but these issues are progressively being addressed, and we do not think investors should wait passively for benchmark changes to resolve strategic underexposure to A-shares.

Benefits of a broader China exposure

We advocate broader China allocations with significant offshore and onshore market exposures to address current typical underexposure to the onshore market. Higher strategic exposure to the onshore market (A-shares) adds value to portfolios in three ways, as shown in Figure 8.

Figure 8. Benefits at a glance



Diversification

Figure 9 highlights low correlations between A-shares and other equity markets. To illustrate the diversification benefits of an "All China" equity allocation that invests across offshore and onshore markets, we also feature the MSCI China All Shares Index (composed of approximately 40% A-shares and 60% offshore China), which clearly also delivers diversification benefits.

Low correlations are partially driven by China's unique economic, corporate and political backdrop. Also, local market participants own a large share of the A-share market, and domestic investors are relatively insulated from global factors and flows. Although increasing foreign participation in the A-share market could drive higher correlations over time, relatively low correlations would continue to be underpinned by any enduring economic, corporate and political asynchrony between China and the rest of the world.

Figure 9. Correlation matrix

	China A-shares	China All Shares	Emerging market equities	Japan equities	US equities	Europe equities	World equities
China A-shares		0.85	0.47	0.26	0.33	0.32	0.35
China All Shares			0.78	0.45	0.52	0.54	0.58
Emerging market equities				0.59	0.71	0.79	0.80
Japan equities					0.58	0.63	0.68
US equities						0.81	0.97
Europe equities							0.92
World equities							

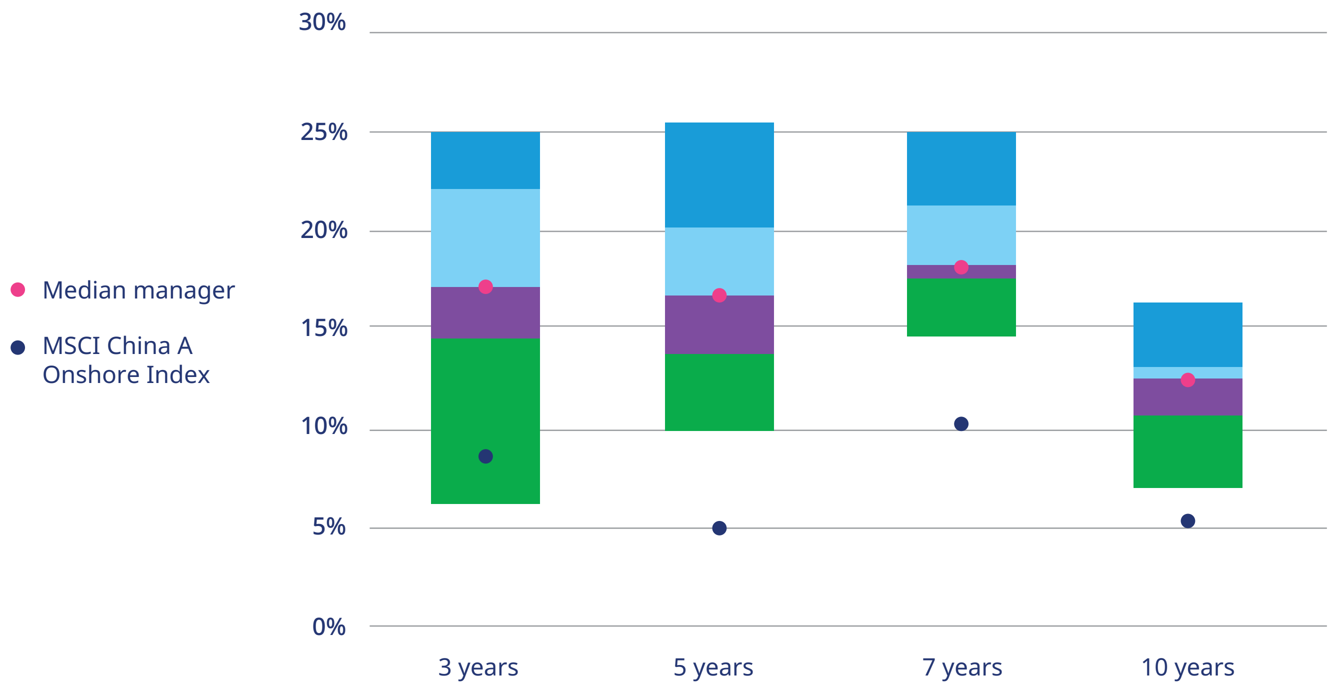
Source: Thomson Reuters Datastream, Mercer Analysis. As at December 31, 2020. Calculated based on historical returns of respective MSCI indices for past 10 years, using weekly USD returns.

Alpha

The A-share market's high retail participation creates inefficiencies that skilled managers can capitalize on. Figure 10 shows that the median manager in Mercer's China A-share universe has comfortably outperformed a relevant index over different time periods.

Although alpha potential should decline as the market institutionalizes, we expect alpha opportunities in this market for many more years. We believe the A-shares market may be the world's most attractive liquid source of equity alpha.

Figure 10. China A-share performance universe: annualized performance (end December 2020)



	3 years	5 years	7 years	10 years
Median annualized outperformance	8.6%	12.5%	8.1%	7.5%

Source: MercerInsight®. As at December 31, 2020 gross of fees.

Growth

As discussed earlier, the rise of China over the coming decades could underpin unique economic and corporate growth drivers that we want broad access to in portfolios. The likelihood of bifurcation between US/UK/Europe/Australia and China has increased in recent years, such that diversified exposure to future global growth may only be achieved with direct exposure to China's full equity opportunity set.

The relationship between economic growth and equity returns is uncertain and variable across markets and time. As our conviction in the relationship between economic growth and equity returns is lower than our conviction in the diversification and alpha benefits of higher strategic exposure to China, we do not view this as a core rationale for our recommendations.

However, broader access to China's growth contributes to the diversification benefit. Looking beyond correlations, we believe long-term diversification is supported by appropriately balanced exposures to key potential growth drivers, acknowledging that the future can play out in ways that relegate unbalanced portfolios to the wrong side of history.[8]

China-specific risks

Similar to other EMs, **corporate governance** in China is still patchy, and China's government still has significant sway over corporate decision-making, directly and indirectly. Foreign investors have limited protection, and corporate disclosures can be restricted on national security grounds. Shareholder dilution has also been common in China.

Across the global investor base, there are different perspectives and beliefs on **social** issues and overarching philosophical divergences about the best way to govern societies, which may impact some investors' appetite for China exposure.

From an **environmental** perspective, China is the highest carbon-emitting economy in the world, but it is also investing heavily in industries to support a transition to a cleaner economy. In 2020, China explicitly stressed environmental objectives, such as "Beautiful China," 2060 net-carbon neutrality, and green development funding. China equity allocations with flexibility to invest across onshore and offshore markets may provide exposure to some of the corporate leaders in/beneficiaries of energy transition (e.g., renewables, battery technology, electric vehicles).

Geopolitical risk exists with any market, but is notable with China because politics and foreign policy will probably feature prominently in the world's response to its strategic rise. The US and China's competing interests have spilled into trade and technology. The US even took steps to limit the investible universe of China stocks for US investors (see our article on former President Trump's Executive Order for details), which also potentially impacts non-US investors. However, sanctions of this nature can actually strengthen the case for higher strategic A-share exposure because they may encourage Chinese companies to list at home. This reduces the offshore opportunity set as a consequence. Geopolitical risk should not preclude China exposure, and actually underpins its role in portfolios as geopolitical shifts could elevate China's importance across the investment landscape.

Although investors should take these risks into account, we do not believe they should preclude higher strategic exposures to China within equity portfolios. However, active management is critical to ensure these risks are considered and to align allocations with investors' beliefs on environmental, governance and social issues.

How investors can implement a broader allocation to China

Investors could address low exposure to China's A-share market, for instance, by switching to a benchmark that includes A-shares at the full inclusion factor. For EM/global equity managers, particularly benchmark-aware strategies, this would encourage greater focus on and potential exposure to A-shares. However, we prefer to address underexposure with **dedicated China equity strategies** because they:

- Facilitate clearly delineated strategic allocations to China, and the flexibility to adjust exposure to targeted levels; also, EM/global managers do not take total portfolio considerations into account in sizing China exposure[9]
- Focus on the China opportunity set, and could offer broader and deeper exposure to it in portfolios; they offer the potential for greater expertise and coverage of onshore equities, whereas many EM/global managers are less familiar with, and relatively new to, the onshore space
- Have demonstrated more convincingly than EM/global managers the ability to generate strong alpha within the China opportunity set

We strongly prefer **actively managed strategies** to gain exposure to China's equity markets, particularly given favorable alpha prospects and greater flexibility to address ESG and other risks.

Our two preferred implementation approaches for an actively managed China equity allocation are to:

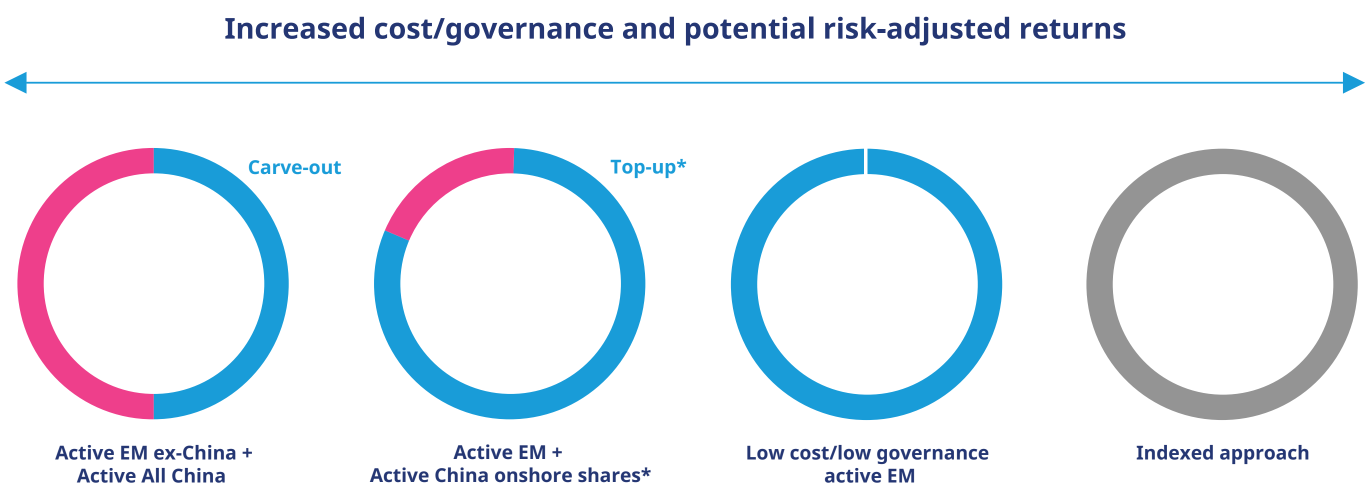
- **Top up** China exposure within a broad EM allocation via a dedicated China A-shares or All China allocation ("All China" approaches invest across China's offshore and onshore markets)
- **Carve exposure out of EM** in a structure with separate dedicated All China and EM ex-China allocations

We recognize, however, that the most appropriate structure for capturing China in portfolios will be heavily dependent on investor circumstances and capabilities. There are various ways to implement the dedicated China allocation within our preferred top-up and carve-out structures, including a single China mandate (China A-shares or All China) or a multi-manager China allocation (e.g. some combination of China A-shares and All China mandates).[10]

We also note that dedicated, actively managed China allocations will not be viable for all investors. For those investors with a lower governance budget and/or lower risk tolerance, China exposure can be gained through low cost/low governance active EM strategies, or through passive approaches, although none of these options fully capitalize on all the benefits of China equity exposure.[11]

We illustrate the spectrum of solutions in Figure 11.

Figure 11. Implementation options



* Top-up allocations with All China Equity strategies may be more appropriate for investors who have a material underweight to the China offshore market.

Figure 12 summarizes potential pros and cons of the top-up and carve-out approaches.[12]

Figure 12. Top-up vs. carve-out: pros and cons

Top-up approach	Carve-out approach
Pros	
Reduces disruption to existing EM/global mandates	Best accommodates an All China strategy to holistically manage risk and capitalize on opportunities across offshore/onshore markets
Provides more flexibility and precision in targeting specific levels of A-share exposure	Avoids overlap issues inherent in a top-up approach as A-shares increase within benchmarks over time
	EM ex-China mandate reduces risk of other EMs being neglected as China increases within EM benchmark
Cons	
All China is our preferred approach to dedicated China allocations, but significant overlap between EM and All China benchmarks mean that A-share mandates will typically be better suited to the top-up approach	Less control over A-share exposure, as managers drive allocations between offshore and onshore markets
As A-share inclusion factors rise in standard indices, overlap and risk concentrations between China A-share and EM/global mandates will increase, which needs to be managed carefully	EM ex-China strategies are relatively new and are predominantly available via segregated mandates, which implies minimum investment sizes that may only be viable for larger investors
China exposure is split across two mandates, which does not achieve a holistic China allocation. For example, many dual-listed stocks have higher valuations onshore than offshore, but an A-share mandate cannot capitalize on that in the same way as an All China mandate	Relative to the top-up approach, higher All China allocations are required to achieve desired strategic exposure to A-shares (given ~40% A-share weight in typical All China benchmarks); although active managers may overweight A-shares vs. benchmark
	The typical benchmarks for All China and EM ex-China mandates are quite concentrated, with approximately 20% of each index represented by the two largest constituents; this can make it challenging for managers to express an active view in these names

Talking numbers — how big should the broader China allocation be?

Broadening the China allocation also means making it bigger, because we want to increase strategic A-share exposure without reducing access to the offshore China market given its importance. So how big should China allocations be? To explore this question for the top-up and carve-out implementation solutions, we performed quantitative modeling to test the impact of and sensitivity to inputs — lower correlations, higher alpha, higher market beta returns — on which a case for higher A-share exposure is predicated.[13]

Quantitative analysis demonstrates that even conservative assumptions about the benefits of diversification, alpha and market beta support materially higher China allocations than typically found in global investor portfolios. Of the benefits, we have highest overall confidence in diversification, and this benefit underpins our baseline recommendations for minimum China A-share allocations in Figures 13 and 14. Higher allocations can be justified once we factor in conservative alpha assumptions, and these are reflected in the upper end of the recommended ranges. We do not need to lean on any assumption that growth drives higher returns, although broader access to China's growth contributes to the diversification benefit. Although higher growth-driven market beta returns could justify larger allocations, the upper end of the ranges are shaped by other considerations such as accessibility, capacity and risk.

Figure 13. How much more A-share exposure should you have?

We advocate a range of 5%-10% on top of emerging markets for a typical equity portfolio

Estimated China A-share allocation %	**0%**	**~5%**	**~10%**	**10%-20%+****
Assumption(s) made	**Higher risk** China equity exhibits higher risk than emerging and developed markets. We assume no benefit from lower correlation, higher alpha, or growth.	**Increased diversification** Low correlation between China A-shares and other equity markets. We assume correlations with developed and emerging markets of 0.4-0.5*.	**Higher alpha** Greater alpha potential in the less efficient onshore China equity market. We assume net 2.5% alpha vs. 0.25% for developed and 0.75% emerging markets.	**Higher growth and earnings** Higher economic growth could feed through to higher earnings growth over time. We assume higher earnings growth of 0.5% (relative to broad EM) over the long term.
Mercer's conviction in assumption(s)	**n/a**	**Moderate to high conviction**	**Moderate to high conviction**	**Lower conviction**

Start with higher risk assumption on the left-hand side; China onshore would not benefit a portfolio if it was just riskier. Then, assume increased diversification — this would merit an allocation of up to 5%. Next, assume higher alpha in addition to increased diversification — this would merit an allocation of up to 10%.

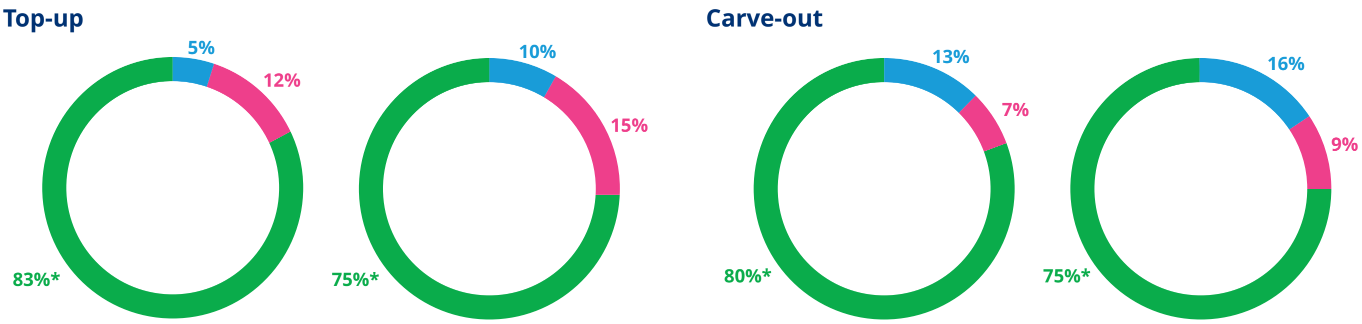
*Correlations assumptions in line with history.

**We do not advocate additional allocations of >10% at this time given wider portfolio risk considerations, our lower conviction in the growth argument, and accessibility/capacity considerations.

Figure 14. Suggested allocations for top-up and carve-out approaches

Top-up	Min weight		Max weight
China A-share	5%	⟷	10%
EM Broad	12%	⟷	15%
Total EM	**17%**		**25%**

Carve-out	Min weight		Max weight
All China	13%	⟷	16%
EM ex-China	7%	⟷	9%
Total EM	**20%**		**25%**



*Denotes developed market exposure

Conclusion

To access a broad range of return drivers within equity portfolios, we recommend EM allocations of at least market weight (approximately 12%[14]). However, to increase portfolio efficiency, we strongly prefer higher allocations up to 25%, driven to a large degree by a much bigger allocation to China A-shares.[15]

Many investors are underexposed to the diversification and return enhancement benefits of China exposure at the total portfolio level. For many investors, listed equities offer the most practical and effective way to address this underexposure. So, in rethinking typical EM/global equity portfolios, we recommend:

- **Broader and bigger China equity exposure** — with higher allocations (approximately 5%-10% of the equity portfolio) to China's A-share market — improving access to China's growth, diversification and alpha opportunities.
- To achieve broader and bigger China equity exposure, our two preferred implementation approaches are:
  - **Top up** China exposure in EM allocations with dedicated actively managed China A-share/All China mandates
  - **Carve out** China from EM, and allocate separately to **actively managed EM ex-China** and **All China** mandates

We acknowledge specific **ESG** and **geopolitical risks** with China equity exposure, but believe many of these can be mitigated with active management and are outweighed by the potential enhancement of portfolio efficiency.

[1] "Emerging" markets as classified by index providers are typically smaller, economically, with stock markets not displaying many of the requirements for developed markets, such as advanced economic development, minimum investability and accessible capital markets. However, they are likely to display signs of strong or rapid economic growth.

[2] Developed market companies derive some of their revenues from EMs, but this is typically only a small proportion of overall revenues (see interactive tool by MSCI: https://www.msci.com/research/global-investing-trends/global-and-regional-revenues. For example, the MSCI North America Index derives ≈70% of its revenue from North American economies and only ≈15% from EMs. The MSCI EM Index derives 85% of its revenues from EMs. So the narrative of investing in US equities to achieve foreign exposure via multinationals has some truth, but it is no substitute for broad access to locally domiciled EM companies.

[3] Mercer's reference portfolios published in 2020, for example, recommended 15%-20% allocations to EM within the equity portfolio, subject to risk preferences.

[4] The CSRC (China Securities Regulatory Commission), PBOC (People's Bank of China), and SAFE (State Administration of Foreign Exchange) combined the QFII and RQFII schemes from 1 November 2020.

[5] The difference in size is much smaller when measured by free-float capitalization.

[6] For example, the two largest China constituents represented ~32% of the China offshore exposure in the MSCI EM Index at the end of December 2020.

[7] MSCI, for example, currently represents China's A-share market at an inclusion factor of 20% in standard indices. The 20% inclusion factor for China A-shares means that only 20% of the available free-float capitalization of China A-share constituents is included in the MSCI EM Index and MSCI ACWI.

[8] With the benefit of hindsight, a concentrated allocation into one single region will always outperform a diversified portfolio; but because we do not know what the future brings, we should position broadly.

[9] This is true for other markets within regional or global mandates, but is more important for China given its compelling benefits within a total portfolio context (refer to pages 7–12). Separately, given the prevalence of myopia in active management, EM/global managers may not adopt the long-term investment horizon that partially underpins our strategic rationale for China exposure.

[10] A multi-manager approach to the dedicated China allocation provides additional flexibility to customize the blend between onshore and offshore exposure in both top-up and carve-out structures.

[11] Low cost/low governance active EM would cover mandates that have structurally higher A-share exposure if managed against such a benchmark (e.g., MSCI EM with China All Shares Index). An indexed approach represents the status quo benchmarked against standard indices without structurally higher A-share exposure. This approach would therefore be the least preferred.

[12] A multi-manager approach to the dedicated China allocation and/or customized benchmarks provide more flexibility to mitigate some of the cons highlighted in Figure 12.

[13] The initial portfolio carries MSCI ACWI weights (88% developed, 12% EM) to which we add China A-shares in 2% increments, funded from the developed markets allocation. For simplicity, we leave the allocation unhedged. A separate paper on EM and hedging will explore the merits of currency hedging for emerging markets in more detail.

[14] Based on MSCI AC World Index weights at the end of December 2020.

[15] This is a recommendation in principle. Asset allocators still need to consider this recommendation in the context of their individual circumstances and total portfolio, and should only act on this after obtaining advice from their investment advisor.

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