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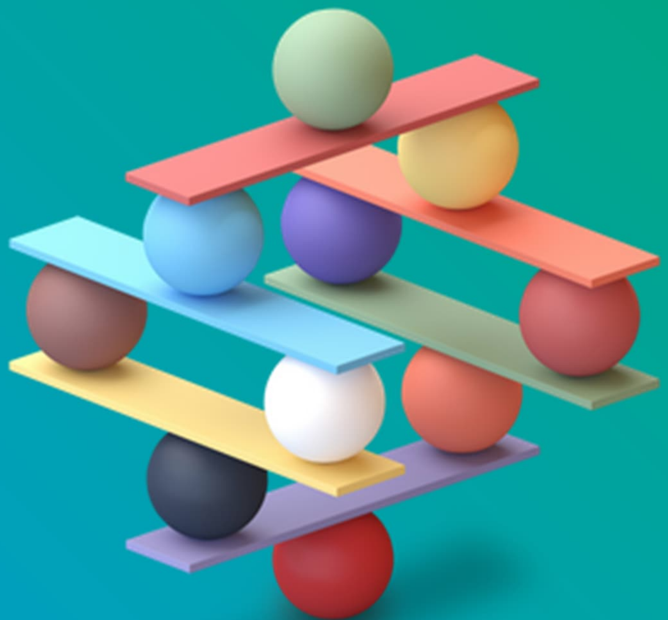
The case for China revisited – Public equities

Summary



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Geopolitical risks have come to the fore in recent months, with tensions over Taiwan prompting a review of exposure to Chinese assets. In this paper, we take a step back and re-evaluate the role of China equities from a total portfolio perspective after taking recent news into account. We conclude that China A-shares still have a potential role to play in global portfolios due to underrepresentation in global benchmarks, significant portfolio diversification benefits and potential for outsized alpha. We are, however, mindful of the potential for asset allocation decisions to be constrained depending on an investor's domicile and indeed their own objectives.

Our current advice is that a strategic allocation to China A-shares in the range of 5-10% of an investor's total equity portfolio is appropriate due to its underrepresentation in global benchmarks, significant portfolio diversification benefits and potential for outsized alpha. For context, the five largest company constituents of the MSCI ACWI equated to ~13% at the end of August 2022[1]. If investors are comfortable with this level of absolute exposure in a few individual companies all listed in one market, it seems reasonable to consider at least similar overall exposure to the world's second-largest stock market, which is composed of thousands of companies.[2]

Events in 2022 have prompted us to review our stance on China. We believe the original investment case remains intact[3], with regulatory and ESG risks unchanged but with policy divergence between China and most other countries now boosting the diversification argument. However, whether or not geopolitical risks have increased following Nancy Pelosi's visit to Taiwan in August is less clear. Using history as a guide, we can see that tensions associated with Taiwan are not without precedent, with flare-ups having occurred several times in the post-World War II era. Russia's invasion of Ukraine and the fallout in markets has increased sensitivity to and awareness of the geopolitical risks associated with Taiwan; however, there is a range of views as to whether the risk of conflict has actually increased.

What is clear is that the risks associated with a China-Taiwan conflict could have a broad range of potential investment outcomes. A material deterioration in relations leading to an outright conflict would probably have investment ramifications well beyond Chinese assets. Removing China A-shares completely from the portfolio would only partly mitigate the drawdown, largely because China and Taiwan, individually or combined, are far more important than Russia to supply chains and the global economy. A conflict could also plausibly trigger one of the greatest global inflationary shocks in history, which would have dramatic implications across asset classes. China is also an important end market for many multi-national companies listed in developed and emerging markets. Cyber warfare would introduce an additional global impact on economies and markets, and clearly nuclear escalation presents scenarios in which investment outcomes may be irrelevant.

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[1] Source: MSCI ACWI as at August 31, 2022

[2] For further perspective, as at end August 2022 a 60/40 portfolio that invests in equities exclusively via the MSCI AC World Index (MSCI ACWI) would have ~3% exposure to Apple, ~2% to Microsoft and ~1% to each of Amazon, Alphabet and Tesla, and ~10% to the top nine companies in aggregate. The China (onshore and offshore) public equity allocation in this same 60/40 portfolio would be ~2%. Following our advice would increase the overall China public equity exposure to 5-8% of the total portfolio, which at the upper end of the range constitutes less than the nine largest companies in MSCI ACWI.

[3] Mercer (2021): Positioning your portfolio for the future of emerging markets

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There are also plausible conflict scenarios in which Chinese assets retain their value despite sanctions for foreign investors; and there are various reasons to believe that the world's response to a China-Taiwan conflict could be quite different to the Russia-Ukraine conflict. Moreover, if mainland China does not invade Taiwan, or if Taiwan ultimately reunites with mainland China without a full-scale conflict, for example, low exposure to China could represent a sizable opportunity cost for investors.

In our view:

1. removing or reducing Chinese exposure from portfolios may not be the most effective response to rising geopolitical risks, partly because it would only provide limited protection across a broad spectrum of "worst-case" scenarios while foregoing potential portfolio efficiency benefits across numerous benign scenarios; and
2. even at the top of our recommended allocation range, China's absolute weight in portfolios is equivalent to the aggregate weight of a small number of the largest individual stocks in standard global benchmarks.

It is clear that increasing geopolitical tensions are beginning to impact the extent to which certain investment opportunities are accessible within investors' portfolios, which can differ materially depending on their domestic political backdrop. While we continue to advocate for meaningful dedicated exposure to China within equity portfolios, investors need to be mindful of the evolving risks of measures in their home countries that seek to constrain overseas investment in China and, conversely, similar restrictions from China and aligned countries towards investing in the US as a response.

In light of the above, we outline three key options for investors to consider (in addition to broad EM allocations):

1. **Strategic China overweight** – capitalize on the portfolio efficiency benefits of China exposure by having an allocation of up to 10% to China A-shares within an investor's equity portfolio. Ensure that the total portfolio includes appropriate hedging exposures (e.g. gold, tail-risk hedging strategies or a broader commodity basket) to mitigate China-Taiwan tail risks and other risks (e.g. inflation).
2. **Limited strategic China overweight** – consider a reduction in the strategic overweight to China A-shares towards the lower end of our recommended 5-10% range, or towards the "full inclusion" index weight (currently equivalent to an overweight vs. standard benchmarks of ~3%).
3. **Strategic China exposure aligned with standard index weight** – strategic China allocations driven by the weights in standard indices such as MSCI AC World Index.

We caution against abandoning basic principles of portfolio diversification and continue to believe in the diversification benefits of exposure to China. We see a full-scale conflict in Taiwan, with broad investment sanctions, as a high-impact event, which would affect all asset classes, if it materialized. **Our preference is for options 1 and 2** above, which provide the potential for broader and more diversified exposure to Emerging Markets, address the underrepresentation of China inherent in standard benchmarks, and, most importantly, are expected to enhance total portfolio efficiency. For all three options above, and more broadly in constructing any risk-efficient portfolio, investors should consider whether they have appropriate hedging exposures to mitigate downside risks across a range of potential scenarios, including those associated with a conflict in Taiwan.

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