NEPC'S SUMMER TRAVEL: PERSPECTIVES ON CHINA

NEPC Research

It has been a longstanding NEPC initiative to maintain a consistent pace of research trips to Asia. Most recently, two NEPC researchers returned from an extended visit to China with a few detours for family and a typhoon. While their trip included the usual due diligence visits with investment managers, they also tapped into local on-the-ground views of China's rapidly evolving capital markets. What follows are their unfiltered perspectives on the unique market dynamics of China's equity and bond markets.

An Equity Perspective: Tim O'Connell

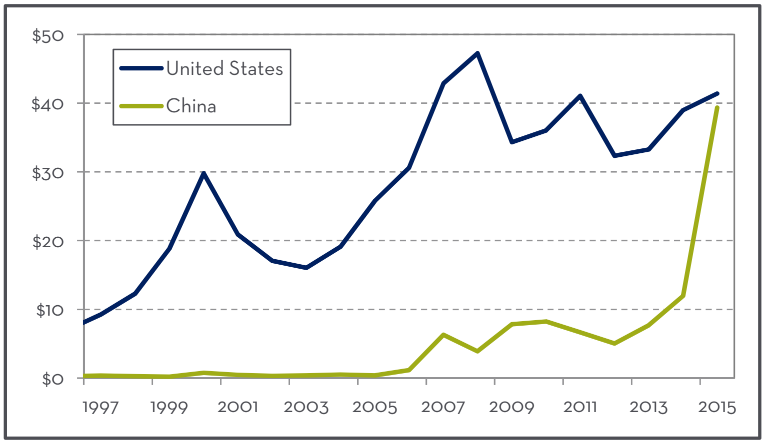
This was a summer of many firsts for me. For starters, I weathered my first typhoon from the safety of a high-rise hotel in Hong Kong. More importantly, this was my first trip to China. During the course of my travels, I spent time in Beijing and Hong Kong with public and private market managers focused on equity-oriented strategies. Rather than concentrate solely on a manager selection process, I wanted to evaluate the underlying structure and dynamics of China's A-share equity market.

There are two major takeaways from my trip: first, the importance of local research staff for an investment manager, and second, the idiosyncratic drivers unique to China. While I headed into my trip knowing the need for local researchers, I assumed the presence of sector or regional analysts in the country would suffice for equity managers. However, after my discussions with a broad range of market participants, I realize the importance of the presence of a local portfolio manager. I found clear benefits to maintaining a key investment decision-maker on the ground in order to leverage local insights and build relationships in the country. This is particularly relevant to Pan-Asian managers who invest broadly in China.

My other major takeaway is the idiosyncratic market drivers unique to China's A-share market. These include the preference for and bias towards local companies, the spectrum of the government's involvement, and the retail driven nature of the A-share market.

The most prevalent theme is the belief that local Chinese companies will almost universally be favored over foreign corporations. I imagine this is partly due to the local consumer's preference for Chinese companies, and the ability of Chinese firms to better understand the local consumer. However, it would be naïve of me to believe the central government does not also play a role in facilitating this behavior. Additionally, it is revealing to see the degree to which provincial and local governments can be both a catalyst for and obstacle to local corporate profitability. Irrespective of these market dynamics, the A-share market re-

Exhibit 1: Total Value of Stocks Traded on Major Indices (USD Trillions)



Source: Bloomberg

mains heavily dominated by retail investors. Some estimate more than 75% of A-share trading volume is driven by retail investors. The value of A-shares has rapidly accelerated on the Shanghai and Shenzhen stock exchanges (Exhibit 1). The growth in the A-share market may increase market volatility but also offers intriguing market inefficiencies and opportunities for active managers with multi-year views.

While my trip was insightful, more questions come to mind. For instance, how can we find ways to invest in a region that may exhibit increased volatility and shareholder turnover? With regulators in China banning the shorting of stocks, how easily can managers exploit market corrections and maintain price discipline? Should the perceived liquidity of the market and the manager's investment horizon require a lockup period for equity strategies? Many of these answers are nuanced but there may be an interesting opportunity for investors willing to stomach the volatility and be patient over a multi-year horizon.

A Bond Market Perspective: Hayley Tran

Lucky for me, typhoons were not on my itinerary and I was able to sneak in a weekend visit home to Vietnam. While it is always good to see family, most of my trip was all work with visits to Beijing and Singapore. I had a chance to sit down with several local emerging market debt (EMD) investment managers. A frequently discussed hot-button issue was the potential inclusion of China in JP Morgan's Government Bond Index-Emerging Markets series. This would be a major event for both global investors and China's local bond market. JP Morgan's indices are the global industry standard for EMD benchmarks. Their influence extends from small individual investors to the largest sovereign wealth funds in the world. Incidentally, many of the EMD managers based in Asia believe China's inclusion in the JP Morgan indices is likely to happen relatively soon. In contrast, the overwhelming majority of their US and UK counterparts expect inclusion to be several years away.

A vote for China by JP Morgan could pave the way for other global bond indices, for instance, Barclays or Citigroup, to include China's onshore government bond market. Some estimate this broad inclusion could result in $100 billion to $150 billion of global fund flows moving into China's bond market. This would be a welcome offset to the ongoing concerns of capital flight out of China.

However, many roadblocks remain for China's inclusion in the JP Morgan index series, largely related to local bond market accessibility issues. These include a quota allocation system for some investors and capital mobility restrictions that could prevent capital from exiting the local market. What emerged as a key theme across my meetings was the level of confidence from Asia-based investors in China's intent and willingness to relax these local bond market restrictions. Several local EMD investment managers pointed to the People's Bank of China's (PBOC) announcement in February as an inflection point. The PBOC announced that a wider array of qualified medium- to long-term investors would be allowed access to local bond markets.

Many investment managers I spoke with viewed this as a dramatic and positive surprise. Skeptics, more so in the US and UK, have focused on the lack of details and how these new rules would align with existing regulations. Undeterred, the more optimistic Asia-based investors went so far as to suggest China's inclusion in the JP Morgan indices could occur in early 2017.

Still, most agree the inclusion of China's local government bond market among major indices is a matter of when and not if. Given the commitment China has demonstrated, we believe the central government will make every effort to attract foreign investment in the local bond market sooner rather than later.

Final Thoughts

There is no better research source than local on-the-ground views. Simply stated, the benefits of experiencing the culture and seeing the investment locale cannot be replicated. Over the years, numerous NEPC professionals have trekked across the globe in search of unique investment strategies and we will continue to keep you apprised of our travels. In particular, we expect research undertaken on this latest trip will lead to specific ideas for client portfolios. If you would like more information on our recent visit or our global perspective, please reach out to your NEPC consultant.

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