

Why super funds are finally investing in China A-Shares

Key points

- *The Stock Connect program has paved the way to international investment in China A-Shares.*
- *Choosing the right external manager involves a rigorous evaluation process and clear criteria.*
- *Frontier recommends an active management approach.*

Institutional investors are raising their allocations to the mainland China share market as restrictions on foreign investors are eased and the potential for higher returns proves hard to resist.

AustralianSuper first considered investing in China in 2013 through an external manager's QFII (Qualified Foreign Institutional Investor) license, but had issues around custody and ownership, according to Australian Super Senior Investment Analyst, Juan Dosio.

By 2018, with the success of the Stock Connect program making access for foreign investors far simpler, AustralianSuper appointed its first external manager to invest in the China A-Shares market.

"Having the Stock Connect was a game changer for us," Dosio said.

China A-Shares: risk and opportunities

The \$US8.8 trillion China A-Shares market is the world's second largest equity market after the US, with over 3000 securities. Index operator MSCI has partially included China large-cap A shares in its emerging markets index as access and regulations improved.

"China A-Shares is a very niche market with unique characteristics and many underlying risks and opportunities," Frontier Advisors Associate, Nadine Hassouna, said.

China A-Shares are dominated by retail investors and have low levels of foreign ownership, which creates an investment opportunity, according to Hassouna. The China A-Shares market is more diverse and has produced historically higher returns than the MSCI China Index, but also has greater volatility.

"If we looked at the data, in the short term it was quite scary. It was quite volatile," Dosio said.

"So, the ability of active managers to decouple from that beta was quite important to us."

Dosio said AustralianSuper wanted an active manager to focus solely on China A-Shares because the fund already had strong exposure to companies in the MSCI China Index through its global and emerging markets managers.

"We were up to our neck with Alibaba and Tencent, so we didn't need more of that."

Frontier generally recommends that investors entering the China A-Shares market take an active management approach via emerging markets managers who can exploit market inefficiencies.

Finding the right manager

AustralianSuper cleared potential China A-Shares managers from an operational due diligence and ESG perspective before making any other assessment. It then selected a manager to trade China A-Shares that:

- was based in mainland China or Hong Kong so they could be "close to the action"
- had an investment team fluent in Mandarin
- had a minimum seven-year investment track record
- had a long-term investment approach characterised by low turnover
- could build a portfolio with a low number of stocks
- could implement specific downside protection.

They also allowed the manager to hold twice the level of cash it normally would permit in comparable circumstances (such as for an emerging markets manager), if the market ran too hot.

"You need to allow for that release valve, and that release valve has to be cash," Dosio said.

His advice to other funds considering investing in China is that they shouldn't increase their exposure to China equities because the MSCI index weightings are increasing, or for greater diversification.

"If you have enough evidence that you can outperform the MSCI ACWI by investing in China A, then do it," he said.

AustralianSuper had 5.788% of its international equities portfolio invested in China at June 30, 2019, according to the fund's annual report, behind only the US (53.618%) and the UK (7.286%).

China A-Shares is a unique market with many underlying risks and opportunities - Frontier is happy to assist clients with any enquiries.

Key questions the panellists answered

- *(16.36m) What are the different ways investors can access China A-Shares and what channel does Frontier recommend?*
- *(35.45m) Do quantitative managers or smart beta strategies have a role to play in China?*
- *(37.55m)? Why did Australian Super choose to invest directly in China A-shares over MSCI Greater China or MSCI China?*