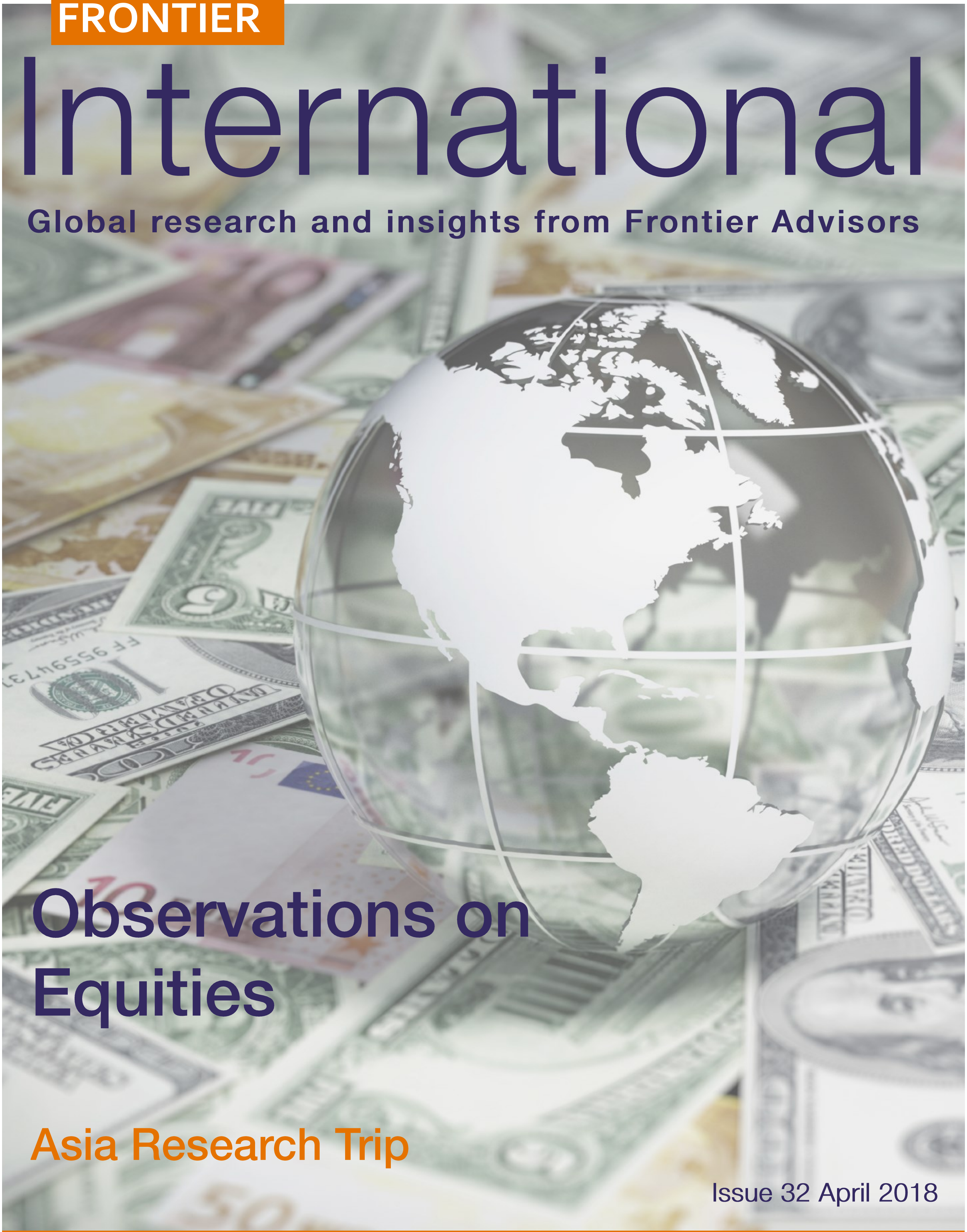
FRONTIER

International

Global research and insights from Frontier Advisors



Observations on Equities

Asia Research Trip

Issue 32 April 2018

FRONTIER ADVISORS

Frontier regularly conducts international research trips to observe and understand more about international trends and to meet and evaluate, first hand, a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high-level assessment on the key areas and observations unearthed during this recent trip. We would be pleased to meet with you in person to provide further detail on these observations.

AUTHOR

Fraser Murray

Fraser Murray is Director of Research at Frontier. In this capacity, Fraser leads the Research Program within Frontier and is the Head of Equities.

Fraser joined Frontier in 2012 and is well known and highly regarded within the investment and funds management communities having previously worked at Ibbotson Associates/Intech Investments for nearly 15 years where he held a variety of roles including five years as Head of Manager Research and five years as Head of Equities and Property. Fraser started his asset consulting career at Towers Perrin in 1994 as a Research Associate in its Melbourne and London offices.

Fraser holds a Bachelor of Commerce with Honours from the University of Melbourne and a Graduate Diploma of Applied Finance and Investments from Finsia, and is a Fellow of Finsia.

AUTHOR

Nathan Bode

Nathan Bode is a Principal Consultant at Frontier having joined the firm as a Consultant in 2012 from Standard & Poor's. His responsibilities at Frontier include providing consulting support to clients, and involvement with both investment and manager research.

Nathan worked for five years within Standard & Poor's Fund Services division and prior that spent four years at Westpac Banking Corporation, where he worked as a Middle Markets Credit Associate, and also in Property Finance as an Assistant Relationship Manager.

Nathan holds a Bachelor of Commerce (Finance Major) and Bachelor of Arts (Chinese Major) from Monash University, and a Diploma of Financial Services (Financial Planning).

The rise of China A Shares - what does this mean for Australian investors?

During March 2018, Frontier visited an array of Asian equities managers in Hong Kong and Singapore to better gauge the opportunity and risks that exists within China A shares. We have outlined our five key learnings in this issue of Frontier International.

A-shares is an expression designating shares that trade on the two Chinese stock exchanges, that is, the Shanghai Stock Exchange and the Shenzhen Stock Exchange.

A-shares are shares of mainland China-based companies and were historically only available for purchase by mainland citizens since foreign investment was restricted. Since 2003, select foreign institutions are allowed to purchase them through a program called the Qualified Foreign Institutional Investor (QFII) system.

China A shares are gathering steam and gaining more and more investor attention. There are a few reasons for this. Firstly, they will shortly be added to the MSCI Indices and the benchmark-oriented thinkers of our industry can no longer ignore China A shares.

Further, this once hard-to-access market is becoming increasingly accessible. Accordingly, this is creating a degree of excitement amongst investors, whilst simultaneously the promotion of China strategies by fund managers has increased.

China A Shares are not an undiscovered opportunity

While China A shares have seen limited investment from foreigners (given this has been limited by small quotas),

there has been considerable investment by locals and China A shares are actually highly liquid and heavily traded already.

As a result, China A share prices reflect a highly invested market. Many Asian fund managers commented on how expensive China A shares were.

On a relative basis, these Asian investors were investing elsewhere in more attractively priced opportunities. This finding was significant when thinking about how Australian investors should think about China A shares.

It seems clear that the China A share market will remain highly volatile and it will likely fluctuate between cheap and expensive over time. The key message is that a fixed allocation to Chinese A shares is not optimal. It appears better to selectively invest in China A shares at the appropriate time, but be lowly invested at other times.

Speaking Mandarin matters now, but may not matter quite so much over the longer-term

Many of the larger companies in the China A share market have reached the point of communicating to potential investors in English, whether via written releases/financial accounts or through communication in person.

However, investing further down the mid and small cap China A shares is a different proposition. Many of these companies still have disclosures/financial accounts only produced in Mandarin and engagement with company management must be in Mandarin.

We found that the genuinely committed Asian equities and emerging markets managers had deliberately hired Mandarin speakers in to their teams to avoid the language barrier opportunities. Not all managers have done this, so we believe Mandarin speakers as part of a team are a comparative advantage.

It is unclear what is the best way to navigate this highly volatile market

It is widely known that the Chinese retail investor dominates the A Share market and is a major contributor to the stock market volatility. We subsequently found out that Chinese equities institutional investors often operate in a similar manner to Chinese retail investors, trading heavily and annual turnover in the order of 500% is common.

Accordingly, most Chinese mainland institutional investors do not invest in the more long-term manner that we expect. Linked to this, there are foreign managers that have a joint venture or an alliance with a Chinese equities manager and we question whether there is truly any meaningful value from these tie-ups, given the investment approaches are often incompatible. Many of the managers we met with acknowledged the limited benefits of their own alliances.

On a related point, according to some of the managers we met with, the local Chinese investors are drawn to the most dynamic stock opportunities that resemble a casino more than a stock market.

Many of the foreign investors in China steer away from some of these highly volatile stocks and were instead drawn to more stable, less exciting China A shares businesses (with less scope for upside and downside). We can understand that many Australian investors might be most comfortable with their managers investing in China A shares via these less exciting investment propositions. We are, however, unsure if that is the best way to maximise returns from China A shares - it may be that capitalizing on the volatility and enduring the wild ride offers better upside.

Manager research commitment varies

Across investment managers, the level of current research commitment to China A shares varies and the level of historical experience in covering China A shares varies significantly.

There are managers that are new to covering China A shares, focus on the English-friendly major stocks as they do not have Mandarin speakers and seemingly do not have plans to add meaningfully to existing research resources.

On the flip side, there are foreign managers that have been covering China A shares for well over a decade, have considerable resources including multiple Mandarin speakers, and are looking down the market cap spectrum for lesser covered ideas.

We believe that suitable resourcing and historical experience with China A shares is likely to be a competitive edge in investing in China A shares for many years to come.

Not without risk

StockConnect is a cross-boundary investment channel that connects the two Chinese exchanges and Hong Kong Stock Exchange. It is clearly enabling foreign investors to invest more heavily in China A shares. It seems a far more friendly system than the previous quota systems for Qualified Foreign Investors (QFI). However, StockConnect does not seem a process devoid of risks. We enquired about the capacity of the StockConnect system to "disconnect".

While most investment managers were quite comfortable with StockConnect, it was conceded that the Chinese government could turn off the market access and, in such a low probability scenario, it was unclear what that would mean for those that owned China A shares via StockConnect.

At a minimum, it would seem that such an event would cause a delay in being able to liquefy a Chinese A share investment. We do not mean to overstate the risks of StockConnect, but we cannot state with certainty that there is no risk.

The final word…

The rise of China A shares is exciting as one of the world's largest stock markets is increasingly becoming available to investors, including Australian funds.

If not already in place, for those managers managing a multi-regional strategy (whether Asian, emerging markets or global equities) and asking for permission to invest in China A shares, we think that Australian investors should be granting this approval, but only if it is evident that the manager has the historical experience and appropriate level of current resourcing.

With the pending benchmark addition of China A shares, we think this is a market that needs to be addressed by fund managers and there is an outperformance opportunity from China A shares. This is, however, a market prone to excesses and a fixed allocation to China A shares appears sub-optimal. We are of the view that it appears better to selectively invest in China A shares at the appropriate time, but be lowly invested at other times and this needs to be incorporated into international portfolio configurations. We continue to look at the best avenues to gain access to China A shares, noting there are pros and cons of mainland versus foreign investors.

About Frontier Advisors: Frontier Advisors is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

Frontier Advisors Pty Ltd ABN 21 074 287 406 AFS Licence No. 241266