# Market insights

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## China: A new opening for investors

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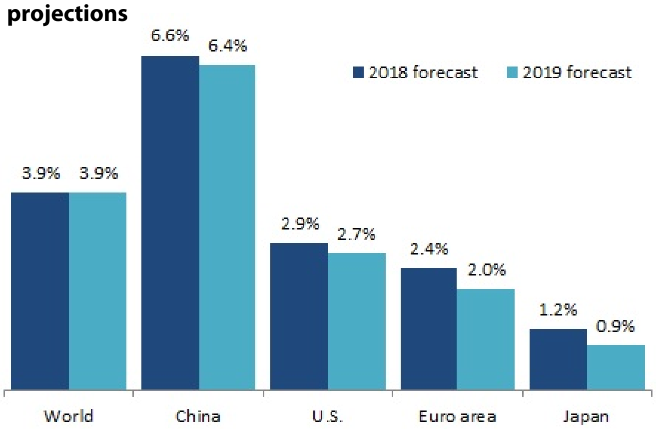
Deng Xiaoping symbolically opened China to the world in 1978, just two years after the passing of Mao, setting in motion a series of pro-market reforms that continue to this day. The sheer extent of China's transformation over the past 40 years can be considered nothing short of a metamorphosis. It has industrialized along a path similar to Asian peers but has done so at stunning speed while establishing leading positions in key industries and emerging technologies, both regionally and globally. Many of China's most promising areas for investment have been largely off-limits to foreigners—until now, that is.

In this paper, we briefly review how China has taken further steps toward capital market integration with the introduction of its Stock Connect programs, which facilitate foreign investment in mainland companies. Investability has improved to the point that MSCI will include a portion of A-share company listings in its flagship indices (the MSCI Emerging Markets Index and *MSCI All Country World Index beginning in June 2018, with subsequent stages of inclusion a strong likelihood. We believe this will benefit broad allocations to Chinese equities for some time as index-sensitive investors drive flows.

Yet, China has recently undergone a series of reforms and technology-driven policy initiatives that are creating powerful investment themes that may be better exploited by active allocations to Chinese equities. A more selective approach, facilitated through A-share investment, may allow investors greater flexibility to target these opportunities more precisely, improving the potential for both alpha generation and risk diversification.

**Figure 1: World Economic Outlook gross domestic product projections**




Source: International Monetary Fund, April 2018

**A big step forward in capital market integration**

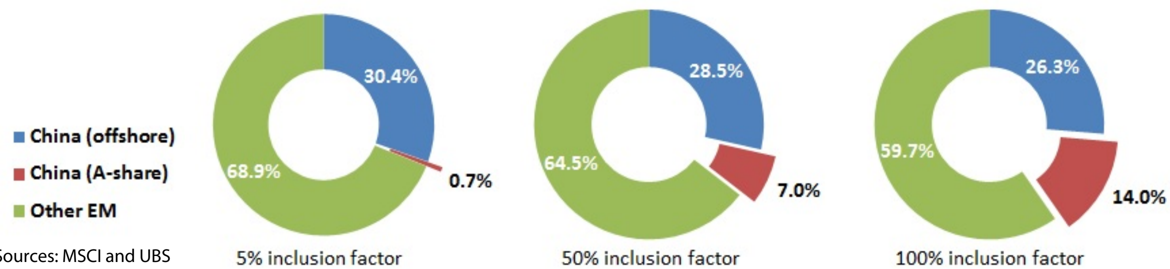
China made its first major step toward granting foreign access to A-shares with the introduction of a Qualified Foreign Institutional Investor (QFII) program in 2002, which roughly corresponded to the timing of its admission to the World Trade Organization. The onerous requirements of who could be granted QFII status would eventually limit the program's ability to attract foreign capital, resembling the experience of similar QFII programs that were used by Taiwan and Korea. The launch of Stock Connect[1] in 2014 was meant to significantly broaden access by bridging the Shanghai Stock Exchange with that of Hong Kong, where foreign investors have considerable experience trading H-shares. The program was expanded in 2016 by bridging the Shenzhen Stock Exchange with Hong Kong. These programs appear to have been successful in increasing intermarket accessibility for both foreign and domestic investors and accelerating alignment with international trading standards. MSCI's decision to include A-shares in its flagship indices is a clear validation of improved investability in this space and should be a catalyst for investment.

### What does MSCI's decision mean for equity allocations?

The A-share inclusion from June through August 2018 will be limited to 5% of the total A-share market, representing just 0.7% of the current value of the *MSCI Emerging Markets Index. This initial step may not significantly move the needle on a broad emerging market allocation, but it is likely just the beginning. The inclusion list has already increased to 232 companies from 222 at the approval stage, up from the original list of 169 companies at the time of initial consultation with MSCI. The potential inclusion universe is much larger, with almost 1,500 A-share listings now accessible through Stock Connect and over 3,150 A-shares currently listed in China. Based on earlier experiences of both Taiwan and Korea, it is conceivable that full inclusion could take as little as five or six years and would represent approximately 14% of the MSCI Emerging Markets Index at current valuations. This would make China A-shares a core component of a broad emerging market equity allocation.

The implications for timing are clear. Most market observers believe index-driven flows will support Chinese A-shares in coming years with the potential for the most significant gains to accrue to holders of out-of-benchmark securities that eventually qualify for inclusion. While this is a compelling technical argument in its own right, we believe a naïve allocation may be suboptimal given the many peculiarities and unique challenges of navigating Chinese equity markets. Rather, an active approach may be the most beneficial way to access this space.

**Figure 2: MSCI Emerging Markets Index composition by 5%, 50%, and 100% A-share inclusion factors at current valuations**




Sources: MSCI and UBS

**The active opportunity**

New developments in China's industrial policy have created durable top-down themes that we think well-positioned, well-managed companies can exploit to the benefit of their shareholders. We discuss these below and integrate a few examples of mainland companies (some widely recognized, some less familiar) that currently are harnessing these developments to their advantage.

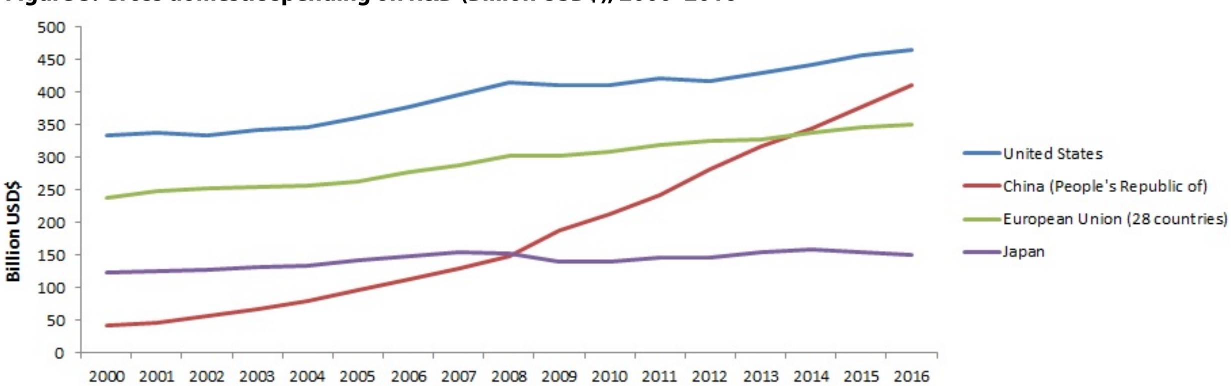
**A shift to technology-focused industrial policy**

Much of China's rapid industrial development can be attributed to its focus on basic infrastructure investment. Various forms of subsidies have aggressively targeted traditional export sectors and capacity in raw factors of production—the so-called *commanding heights*. While this produced the intended growth in targeted areas, it also brought predictable and unsustainable overcapacity (steel production is a classic example), pollution and resultant health issues, and lopsided trade flows, among countless other imbalances that have rippled through the economy. Diminishing returns to investments in these areas have become more evident in recent years to the point they cannot be ignored. However, some welcome changes appear to be in progress.

While China is still far from reliance on price signals that are generated by a free-enterprise market system, its industrial policy has recently begun to rebalance by rationalizing supply-side capacity and encouraging a continued shift toward liberalizing its domestic consumer economy, fueled by significant private sector wealth accumulation. The Stock Connect[1] programs are also an attempt at liberalizing the financial sector to promote more efficient investment. Among these broader improvements, the focus of our discussion below relates to Xi Jinping's "Made in China 2025" program, which is aimed at innovating China's manufacturing infrastructure through broad integration of smart technologies with an embedded focus on environmental sustainability. The longer-term goal is to drive the world's second-largest economy to be a global leader in advanced clean manufacturing technologies by 2035. China's initiative has been progressing quickly, and we estimate that it is just a few years behind a program with similar aims instituted by the German government called "Industrie 4.0."

The ramp-up in technology has been aided by a considerable commitment to research and development (R&D) by Chinese companies and by state-sponsored enterprises (Figure 3). China has over 3 million science and engineering graduates and currently accounts for over 25% of global R&D spend, which is just behind the U.S. at approximately 30%. As a percentage of gross domestic product, R&D expenditure is expected to rise from about 2.1% today to 2.5% by 2020. These investments are clearly leading to increases in home-grown technological advancements. Moreover, China's latecomer status on the world stage is affecting the size and scale economies of these investments.

**Figure 3: Gross domestic spending on R&D (Billion USD$), 2000–2016**




Source: Organisation for Economic Co-operation and Development

## Lack of legacy infrastructure

The rapid speed with which China is industrializing is due in part to its relatively recent emergence as an economic power. While Asian peers were quick to rebuild critical infrastructure following World War II, China was mired in the self-destructive, inward-looking policies of the Cultural Revolution well into the 1970s. One result was that despite its landmass and wealth of human capital, China remained a largely agrarian and underdeveloped economy with minimal infrastructure. Into the 1990s, this literally presented a greenfield opportunity to lay down modern infrastructure with China's natural cost advantages that stem from both scale and population density.

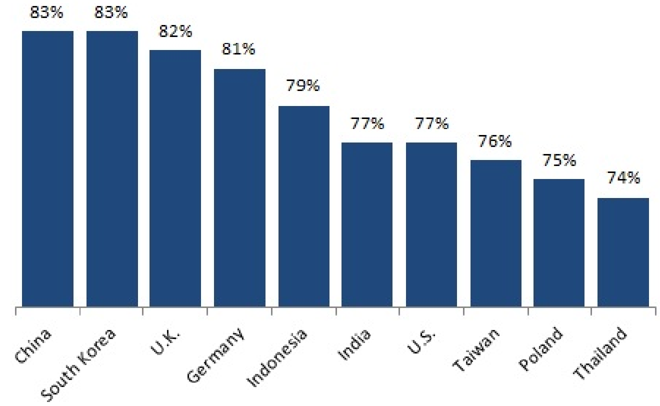
## The convergence of tech and scale is a powerful theme

One example of where we see the convergence of new technologies and the opportunity for scaled investment in infrastructure are in high-speed rail networks. With 26,000 kilometers in operation, China currently has nearly double the rest of the world combined with another 10,000 kilometers under planned construction. At this volume of investment, the natural competition among numerous suppliers (construction contractors, operators, signaling systems suppliers, equipment makers, etc.) necessitates innovation. For investors, knowing the idiosyncrasies among these various suppliers is key to identifying the most profitable investment in this space. In addition, the extensive infrastructure buildout facilitates the flow of goods, people, and information to the hinterland, presenting a whole different set of investment opportunities through the variety of externalities that are created.

E-commerce is another example where the relative lack of competition from legacy brick and mortar infrastructure has contributed to investment profitability. This effectively has provided Chinese online retailers a first-mover advantage, which was further aided by restrictions on foreign e-commerce competitors. Online sales have continued to grow at upwards of 30% annualized (per first-quarter 2018 results), driving overall retail sales growth of 9% to 10% year over year in China. Figure 4 reveals that online retail penetration reached 83% in the second quarter of 2017, the highest in the world. This is helping produce global champions in e-commerce.

One widely cited example is Alibaba Group Holding Ltd., a market leader and globally expanding household name, with over 540 million mobile monthly active users. It achieved a record $25 billion in sales on Singles' Day[2] in 2017, up 39% from the prior year. For context, total sales on this one day outpaced the collective $19 billion spent by American consumers online over the five-day period from pre–Black Friday through Cyber Monday in 2017. Over 40% of the brands participating in this sale were non-Chinese. And Alibaba is not just another actor attempting to mimic Amazon; the company is also at the leading edge of developing cloud-computing technologies through its AliCloud venture, which should be a new growth engine for the company.

**Figure 4: Markets with highest online shopping penetration as % of internet users**




Source: Statista, Q2 2017

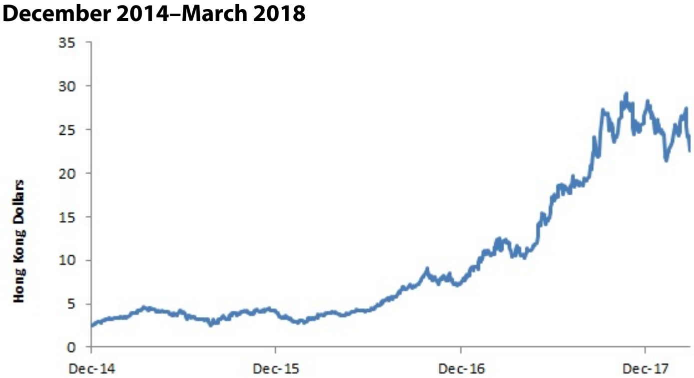
Investors do not need access to A-shares to invest in Alibaba, as it is already listed in the U.S. and is considering additional listings in Hong Kong. However, Alibaba and other major tech champions have a dire need for the rapid development of the internet infrastructure, logistics, and financing innovations that many smaller mainland companies are providing. The multitude of supporting companies that form the backbone of e-commerce is, of course, more accessible through A-share listings.

## Leapfrogging

Beyond the more direct investment opportunities related to infrastructure buildout as noted above, the critical mass of technologies being developed are increasingly finding innovative applications within nontargeted sectors. Their wide availability presents a kind of "free lunch" for companies that can creatively harness them, specifically within old-economy sectors. This is allowing some Chinese companies to leapfrog the global competition in established industries to take leading positions.

One example is Lynk & Co., a 50%-owned joint venture of Chinese auto manufacturer Geely, which is focused on the global trends toward network connectivity and car sharing. Lynk uses the compact, modular powertrains from Volvo (acquired by Geely in 2010), which will be available in hybrid and plug-in hybrid versions, with Compact Modular Architecture that will also allow for pure electric versions.

**Figure 5: Geely share price, Hong Kong Dollar, December 2014–March 2018**

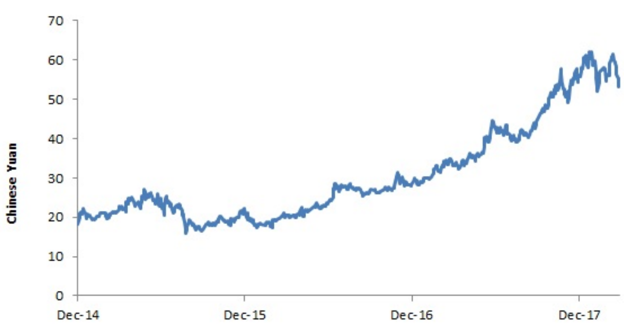



Source: Bloomberg

The Lynk 01 SUV was launched in late 2017 in China at a starting price under USD$24,000 and comes with cutting-edge features, including a subscription service to a dedicated app store, always-on internet connectivity, a personal cloud for the driver, and the world's first in-car share button for car sharing. The company also has innovative plans for foreign distribution; it is scheduled to launch in Europe in 2019 and will target the young, urban segment under a subscription-based system with pop-up shops and direct online sales as opposed to dealership networks. Perhaps unsurprisingly, management considers its competition to be ride-booking services such as Uber rather than traditional automakers.

Another innovator is making its presence felt in the world of household appliances: Midea Group, an A-share-listed company offering air conditioners, refrigerators, and washing machines, has 17 R&D centers globally with over 10,000 R&D staff. With 4% of revenues spent on R&D, the company is seeking to be a leader in smart home appliances, which was further aided by its purchase of Toshiba. The company also acquired German robot manufacturer KUKA in 2016 and is now a major innovator in automation. We believe that robot penetration globally is in its infancy and that Chinese companies such as Midea will be increasingly important players. The domestic market in China for robotics is particularly attractive due to a relatively low installed base and high wage growth as well as the trends supported by the 2025 initiative.

**Figure 6: Midea share price, Chinese Yuan, December 2014–March 2018**




Source: Bloomberg

**Conclusion**

China represents an incredibly important growth story for global investors, and access to it is drastically improving through recent efforts toward capital market integration. A revised focus on technology and efficiency-inspired infrastructure developments—and the opportunities that arise directly from them and from the creative application of these technologies further afield—are investment themes that should persist for a long period. Directionally, there is little doubt among most observers that China is coming up the value chain and will compete more convincingly as a global competitor. We share these broad views.

However, investing in China is not without its attendant risks. We alluded to distortions created by industrial policy. Additionally, the economics of a so-called land grab cannot last forever; installed infrastructure inevitably will age, similar to what more developed economies are facing now. Moreover, we can also add significant increases in debt, a rapidly aging population, and risks of global trade protectionism to the current list of worries. The mention of all of this is not to throw a wet blanket on the broader investment opportunity but is intended merely to acknowledge that certain companies are better positioned for these risks and we believe they can be identified through research. In other words, blind allocations to Chinese equity markets may not be the best way for global investors to access this space, even though we believe that flows into China's equity markets will be broadly supportive as index inclusion continues. We think investors can benefit from a dedicated, active allocation within what is still a relatively nontransparent, inefficient, and evolving capital market.

1. The People's Bank of China governor recently quadrupled the daily quota for Stock Connect and spoke of potential expansion of the Stock Connect program to bridge the London and Shanghai Stock Exchanges.

2. Singles' Day, celebrated each year on November 11, is a holiday popular among Chinese youth that celebrates their pride in being single.

Alpha measures the excess return of an investment vehicle, such as a mutual fund, relative to the return of its benchmark, given its level of risk as measured by beta. Alpha is based on historical performance and does not represent future results.

Diversification does not ensure or guarantee better performance and cannot eliminate the risk of investment losses.

**MSCI Emerging Markets Index (Net)**

The Morgan Stanley Capital International (MSCI) Emerging Markets (EM) Index (Net) is a free-float-adjusted market-capitalization-weighted index that is designed to measure large- and mid-cap equity market performance of emerging markets. The MSCI EM Index (Net) consists of the following 24 emerging markets country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, the Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and the United Arab Emirates. You cannot invest directly in an index.

**MSCI All Country World Index (Net)**

The Morgan Stanley Capital International (MSCI) All Country World Index (ACWI) (Net) is a free-float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI (Net) consists of 46 country indices comprising 23 developed and 23 emerging markets country indices. The developed markets country indices included are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States. The emerging markets country indices included are Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and the United Arab Emirates. You cannot invest directly in an index.

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Stock values fluctuate in response to the activities of individual companies and general market and economic conditions. Foreign investments are especially volatile and can rise or fall dramatically due to differences in the political and economic conditions of the host country. These risks are generally intensified in emerging markets.



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