Mercer

welcome to brighter

Positioning your portfolio for the future of emerging markets

The case for a dedicated China equity allocation

Highlights

At a glance

We believe emerging markets (EM) should be a core allocation in a well-balanced equity portfolio. China's rapidly diversifying and increasingly consumption-led economy is significantly underrepresented in both standard benchmarks and many investors' equity portfolios, including in those with a broad allocation to emerging markets.

Headline exposure to China in emerging market equity indices is, for historical reasons, heavily tilted toward its offshore equities, which are primarily listed in Hong Kong and the US. This overlooks the likelihood that the future dynamics of China's economy will be increasingly reflected in its onshore equity market, often referred to as China A-shares. For this reason, we believe investors should have a larger allocation to China's onshore market through a dedicated China equity allocation.

Although higher economic growth is often touted as the primary reason for allocating to China's onshore markets, growth should be seen as just an additional and less certain benefit. The real attraction stems from the enhancements a standalone allocation can make to an overall equity portfolio, due to its low correlation with other equity markets and the abundance of alpha opportunities.

The case for emerging markets in general

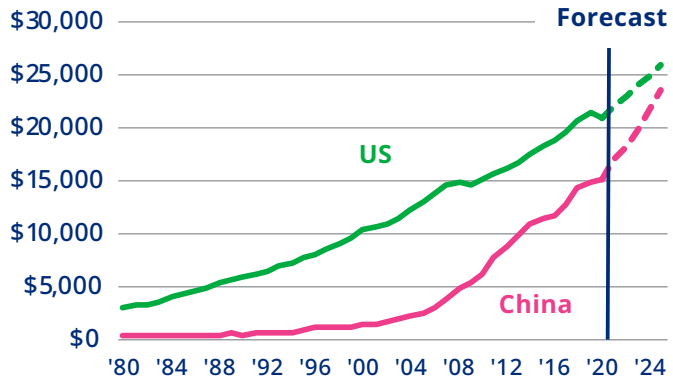
Our case for investing in emerging market equities is predicated on the diversification of long-term return drivers and the potential for higher returns. In terms of their "market weight," EMs represented around 12% of the MSCI All Country World Index (ACWI)[i] on December 31, 2020. We believe equity portfolios should have a strategic EM allocation of at least market weight, but preferably up to 25% of the equity allocation, with any overweight driven largely by China A-shares exposure.

The rise and rise of China

China has outgrown most major economies over the last couple of decades and is likely to continue to do so for some time. In the last 10 years, China has transitioned from exports, infrastructure and business investment to more balanced growth that is less reliant on trade and more focused on consumption and services. China's Five-Year Plan for 2021-2025 explicitly focuses on productivity-enhancing investments that should lead to higher incomes. These investments also support consumption and higher value-added sectors such as tourism, entertainment, healthcare and renewable energy.

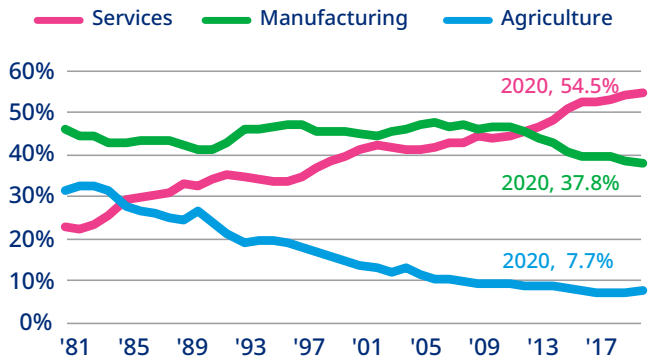
Figure 1. China's economic trajectory

GDP size of China and US



Source: IMF. GDP size, billions, current prices, US dollars. As at December 31, 2020

Share of Chinese GDP by sector



Source: Bloomberg. Percentage of nominal GDP. As at December 31, 2020

[i] Developed market companies derive some of their revenues from EMs, but this is typically only a small proportion of overall revenues. For example, the MSCI North America Index derives ≈70% of its revenue from North American economies and only ≈15% from EMs. The MSCI EM Index derives 85% of its revenues from EMs. So the narrative of investing in US equities to achieve foreign exposure via multi-nationals has some truth, but it is no substitute for broad access to locally-domiciled EM companies.

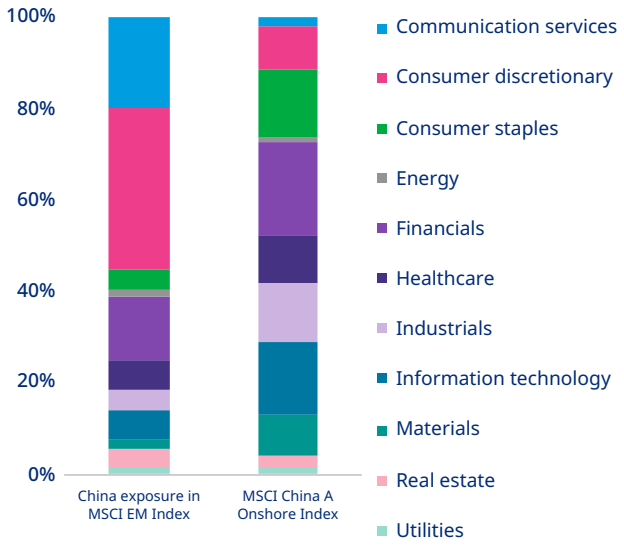
China's dim sum equity market

Like a dim sum feast with a large range of dishes, Chinese equities come in many forms, but they can be grouped into onshore and offshore markets.

The offshore market is primarily composed of shares listed in Hong Kong and the US, and is easily accessible to global investors. The onshore market is primarily composed of China A-shares, listed in Shanghai and Shenzhen, which have become much more accessible to foreign investors.

The onshore market is increasingly important for broad access to China's economic and corporate growth. It is larger than the offshore market by market cap and number of stocks. It is also more diverse and tilted more evenly across areas of future domestic consumption, providing access to economic segments not well represented offshore, such as leisure, food and beverages, media and areas of technology.

Figure 2. Sector composition of China A-shares vs. China exposure in MSCI EM Index



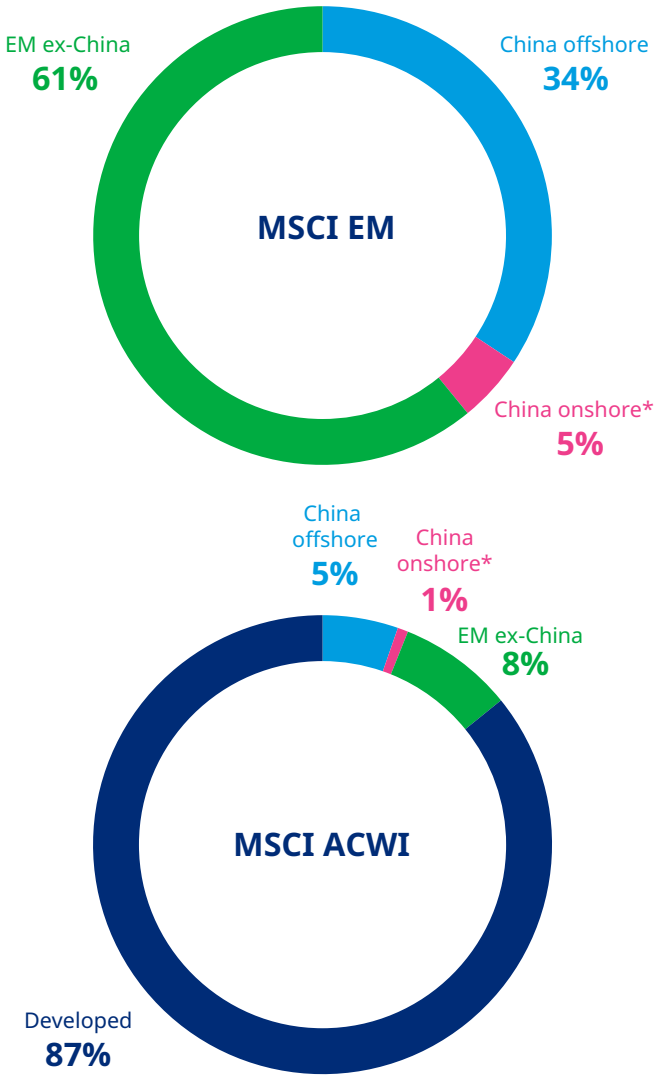
Source: Thomson Reuters Datastream, Mercer Analysis. As at December 31, 2020.

As China's onshore capital markets develop and mature, we expect them to be increasingly important venues for new listings, which should strengthen the strategic relevance of A-share exposure over time. With China's policy agenda increasingly focused on domestic consumption, innovation and high value-added segments, such as tech/healthcare, we believe critical economic and corporate growth exposures may only be fully accessible via the A-share market.

China A-shares are underrepresented in equity indices

Despite China's high representation in EM indices, this exposure is heavily tilted toward the offshore market, while the onshore market is significantly underrepresented. This limits the access to China's economic and corporate growth drivers, and may represent an opportunity cost in terms of potential portfolio efficiency.

Figure 3. MSCI EM Index and ACWI in December 2020



Source: MSCI. December 31, 2020. *China A-shares constitute the majority (>99%) of China's onshore equity market. Index weights have been rounded, so may not add to 100.

Key benefits of a broader China exposure

We advocate broader China allocations to address current typical underexposure to the onshore market. Higher strategic exposure to the onshore market adds value to portfolios in two principal ways: portfolio diversification and higher alpha.

A-shares have low correlations with other equity markets — partially driven by China's unique economic, corporate and political backdrop — which increases portfolio diversification. High retail participation creates inefficiencies that skilled managers can exploit, and in our opinion the A-shares market may be the world's most attractive liquid source of equity alpha.

We believe long-term diversification is supported by appropriately balanced exposures to key potential growth drivers, acknowledging that the future can play out in ways that relegate unbalanced portfolios to the wrong side of history.

The rise of China over coming decades could underpin unique economic and corporate growth drivers that we want broad access to in portfolios. The likelihood of bifurcation between US/UK/Europe/Australia and China has increased in recent years. So, diversified exposure to future global growth may only be achieved with direct exposure to China's full equity opportunity set rather than exposure that is dominated by China offshore shares and companies listed in developed and other emerging markets that earn revenues from China.

China specific risks

Similar to other EMs, corporate governance in China is still patchy, and China's government still has significant sway over corporate decision-making, directly and indirectly. Foreign investors have limited protection, and corporate disclosures can be restricted on national security grounds. Shareholder dilution has also been common in China.

Across the global investor base, there are also different perspectives and beliefs on social issues and overarching philosophical divergences about the best way to govern societies, which may impact some investors' appetite for China exposure.

From an environmental perspective, China is the highest carbon-emitting economy in the world, but it is also investing heavily in industries to support a transition to a cleaner economy. In 2020, China explicitly stressed environmental objectives, such as "Beautiful China," 2060 net-carbon neutrality, and green development funding.

Geopolitical risk exists within any market, but it is notable with China because politics and foreign policy will probably feature prominently in the world's response to its strategic rise. We believe this risk actually underpins China's role in portfolios, as geopolitical shifts could elevate the country's importance across the investment landscape.

Though investors should take these risks into account, we do not believe they should preclude higher strategic exposures to China within equity portfolios. However, active management is critical to ensure these risks are considered and properly managed.

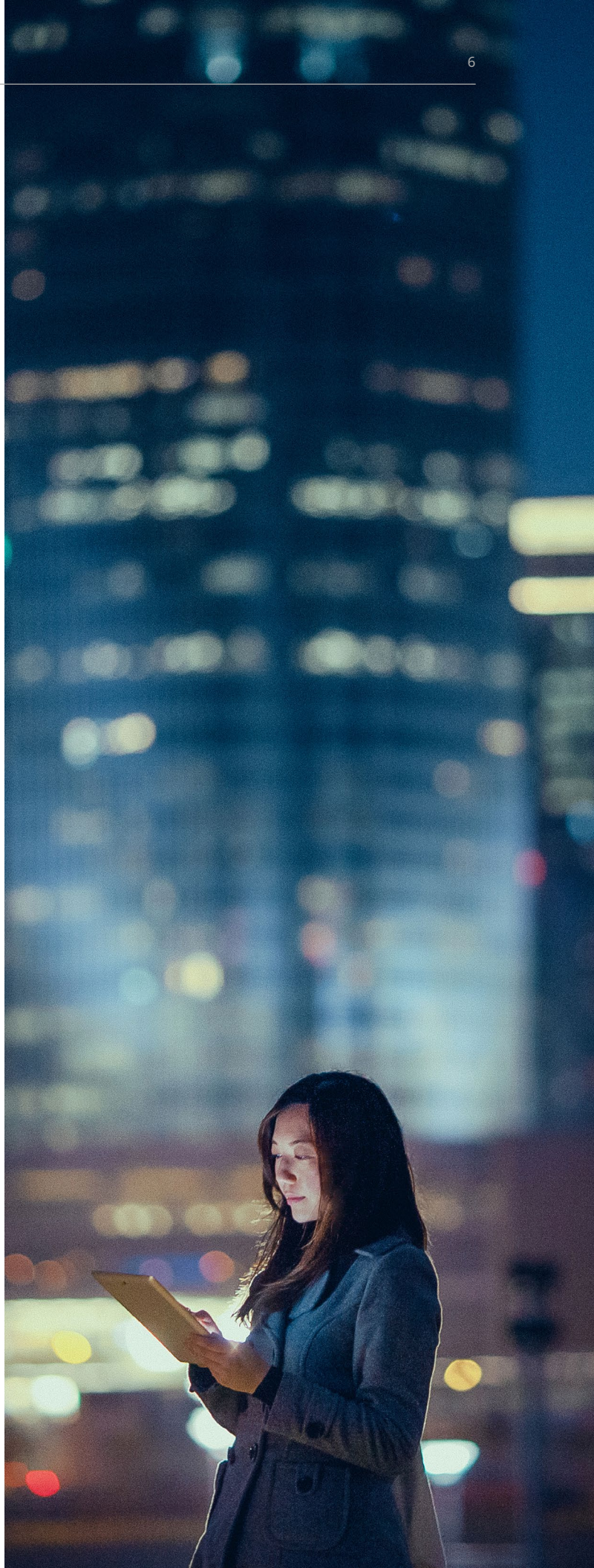
How investors can implement a broader allocation to China

We prefer to address underexposure to China with **dedicated China equity strategies** because they facilitate a clearly delineated strategic allocation to China, and the flexibility to adjust exposure to targeted levels.

Dedicated strategies are focused on the China opportunity set, well positioned to capitalize on alpha opportunities, and can be expected to offer broader and deeper exposure in portfolios. They offer the potential for greater expertise and coverage of onshore equities, whereas many EM/global managers are less familiar with the onshore space.

We strongly prefer actively managed strategies to gain exposure to China's equity markets, particularly given favorable alpha prospects and greater flexibility to address ESG and other risks. We have two preferred implementation approaches for an actively managed China equity allocation. One approach is to top up the China exposure within a broad EM mandate via a separate dedicated China A-shares or All China equity allocation (the latter investing across both offshore and onshore markets). Another approach is to carve China out of EM in a structure with separate EM ex-China and All China allocations. We recognize, however, that the most appropriate structure for capturing China in portfolios will be heavily dependent on investor circumstances and capabilities. There are various ways to implement the dedicated China allocation within our preferred top-up and carve-out structures, including a single China mandate (China A-shares or All China) or a multi-manager China allocation (e.g. some combination of China A-shares and All China mandates).[ii]

Dedicated and actively managed China allocations will not be viable for all investors. For those investors with a lower governance budget and/or lower risk tolerance, China exposure can be gained through low-cost/low-governance active EM strategies, or through passive approaches, although none of these options fully capitalize on all the benefits of China equity exposure.



[ii] A multi-manager approach to the dedicated China allocation provides additional flexibility to customize the blend between onshore and offshore exposure in both top-up and carve-out structures.

Conclusion

Many investors are underexposed to the diversification and return enhancing benefits provided by onshore China exposure at the total portfolio level. China is significantly underrepresented in standard benchmarks and many investors' equity portfolios.

We acknowledge specific ESG and geopolitical risks with China equity exposure, but believe many of these can be mitigated with active management and are outweighed by the potential enhancement of portfolio efficiency.

Within equity portfolios, we recommend EM allocations of at least market weight but, in pursuit of portfolio efficiency, we strongly prefer higher allocations up to 25% driven to a large degree by a much bigger allocation to China A-shares.

Reshaping the future.

About Mercer

At Mercer, we believe in building brighter futures.

Together, we're redefining the world of work, reshaping retirement and investment outcomes, and unlocking real health and wellbeing. We do this by meeting the needs of today and tomorrow. By understanding the data and applying it with a human touch. And by turning ideas into action to spark positive change.

For 75 years, we've been providing trusted advice and solutions to build healthier and more sustainable futures for our clients, colleagues and communities.

Welcome to a world where empathy and economics make a difference in people's lives.

Welcome to brighter.

How we can help

Continuously rethinking purpose and priorities drives HR transformation. Shaping the future of work requires improved strategies around investment and retirement, health and wellness benefits, talent and communications. We believe in the value of investing in the future to build resilience for your business and your employees.

Investments and retirement require sophisticated solutions. We approach these with a big-picture view that prioritizes long- term financial wellness. We offer research and advice on assessing risk and designing benefits programs while keeping in mind the need to optimize throughout changing times.

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