

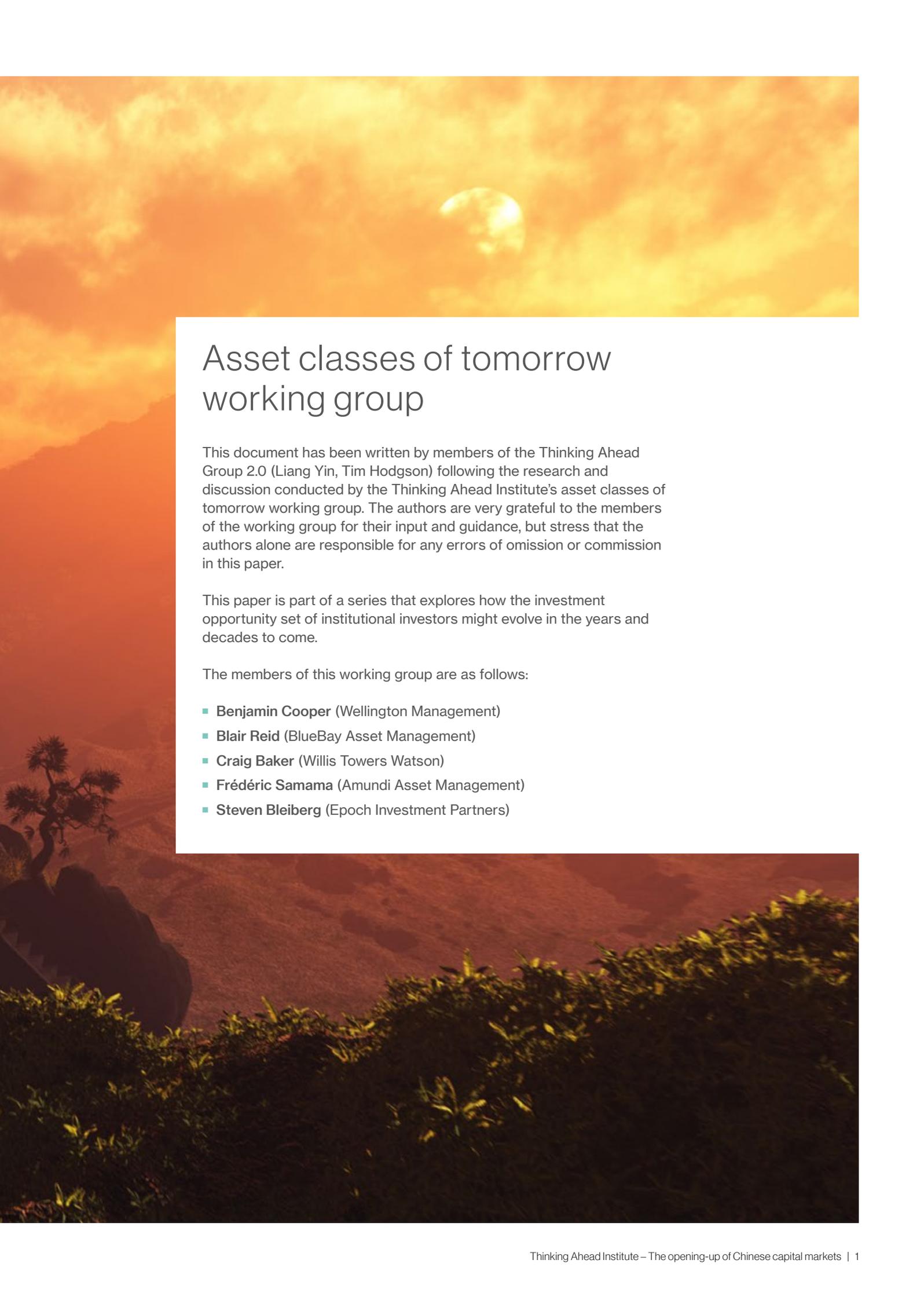
Thinking Ahead Institute

The opening-up of Chinese capital markets

Eight questions answered







Asset classes of tomorrow working group

This document has been written by members of the Thinking Ahead Group 2.0 (Liang Yin, Tim Hodgson) following the research and discussion conducted by the Thinking Ahead Institute's asset classes of tomorrow working group. The authors are very grateful to the members of the working group for their input and guidance, but stress that the authors alone are responsible for any errors of omission or commission in this paper.

This paper is part of a series that explores how the investment opportunity set of institutional investors might evolve in the years and decades to come.

The members of this working group are as follows:

- Benjamin Cooper (Wellington Management)
- Blair Reid (BlueBay Asset Management)
- Craig Baker (Willis Towers Watson)
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In short

1 The opening-up of China – what exactly does it mean?

China's vast capital markets, including the world's second largest equity market and second largest bond market, are increasingly accessible by investors outside China.

2 Why does China want to open up?

It is in China's long-term economic interest to do so. It is also driven by the geopolitical motivation of restoring its great power status in the world.

3 What does index inclusion mean for investors?

The most direct impact of index inclusion is the increased passive investment that tracks those indices. More importantly considerably more assets use them as important references for allocation.

4 Is investing in China now as unrestricted as investing in developed markets?

No, despite many positive developments. But accessibility issues are expected to be gradually addressed over time, at a pace that Chinese authorities deem appropriate.

5 How committed is China to the opening-up process? Might China re-close the door?

China is seriously committed to the opening-up process, as shown by its four-decades-long track record. To reverse this process is not compatible with its geopolitical aspiration and its mentality towards building power.

6 Why do western investors want to own Chinese onshore assets?

(1) A strong long-term diversification benefit (2) plenty of headroom for active management to exploit market inefficiencies (3) a hedge for a new world order.

7 What are the risks and challenges?

Restricted outbound investment is a potential source of risk that could cause market disruptions. There are legitimate corporate governance concerns. The risk of accounting fraud is also significantly higher than in developed markets.

8 So, what is the final verdict? Do opportunities outweigh risks and challenges?

The opening-up of China is likely one of the biggest changes to the investment opportunity set global investors will witness in their lifetime. Investing in China carries risks that investors should carefully examine but not investing in China could potentially present an even greater opportunity cost.

1. The opening-up of China – what exactly does it mean?

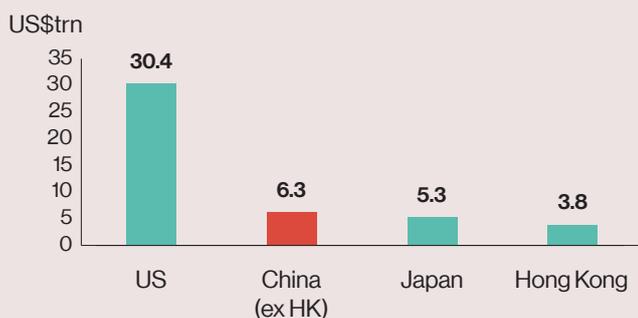


December 2018 marked the 40th anniversary of China's reform and opening-up policy (改革开放), which was launched under the leadership of Deng Xiaoping at the 1978 Third Plenum. The opening-up of China is therefore not exactly a new phenomenon.

While the early stage of China's opening-up policy favoured companies making foreign direct investments (these are deemed to be more sticky), China has in recent years entered a new phase of opening up its domestic capital and financial markets to foreign investors. This is, by definition, expanding the investment opportunity set of those investors that are outside China.

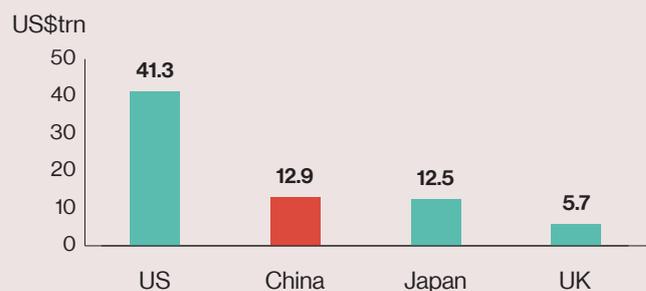
In the 30 years since two major stock exchanges were established in 1990, China's capital markets have grown at an astonishing rate, underpinned by rapid economic expansion. Today, China is home to the world's second largest stock market and also the second largest bond market (Figures 1 & 2). In the unlisted space, according to MSCI, China's real estate market accounts for more than 25% of the global total. Chinese internet and technology firms are also capturing a growing share of global private equity and venture investment. In 2018, an estimated US\$81bn were invested in Chinese start-ups – 32% of invested global venture capital compared to 47% received by US start-ups ([Bain](#)).

Figure 1 – Stock market cap (2018): US\$trn



Source: The world bank, BIS

Figure 2 – Total amount of debt securities outstanding (2018): US\$trn



Source: The world bank, BIS

So far so good. The world's second largest economy has domestic capital markets commensurate with its economic status. Here comes the twist. Historically, foreign investors' access to Chinese onshore capital markets has been very restricted. And that contributed to very low foreign ownership (Figures 3, 4 & 5) compared to other countries.

Since the beginning of the 21st century, barriers to foreign ownership have been gradually reduced through a process that is carefully sequenced and heavily managed by the Chinese authorities. Earlier moves were associated with a fairly onerous approval process and aimed at limiting how much money – through imposing quotas – each investor was allowed to put in.

China significantly upped its game by launching a number of programmes including Stock Connect in 2014 and Bond Connect in 2017. These developments are viewed by some investors to have revolutionised accessibility to this enormous market. Trillions of dollars' worth of Chinese onshore assets are now, in theory, within reach for foreign investors.

From the perspective of the investment opportunity set, the significance of this development is underpinned by both the magnitude of the change and the non-linear nature of the change. Imagine that a large part of Europe declared today that they wanted all foreign investors to liquidate their holdings within six months. That resembles the nature of the opening-up of China, of course in the opposite direction.

Figure 3 – Stock market (foreign holdings as % of total market cap)

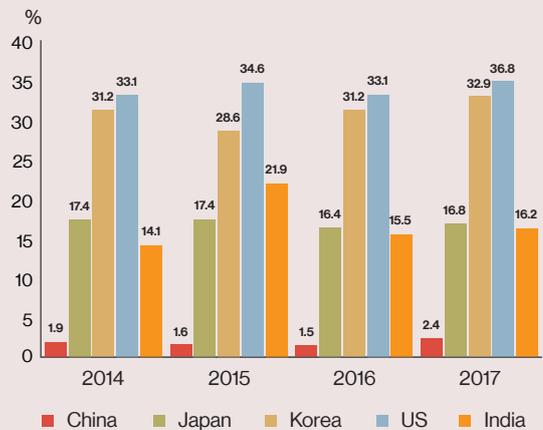
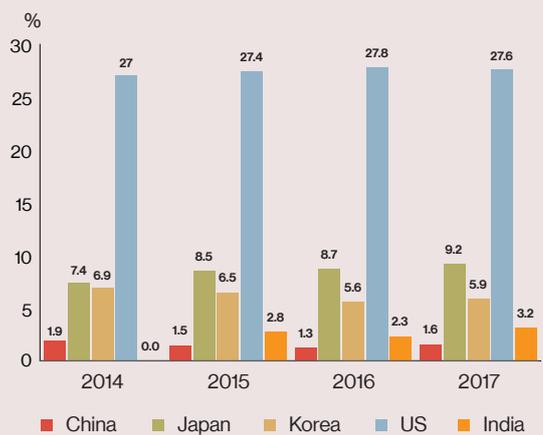
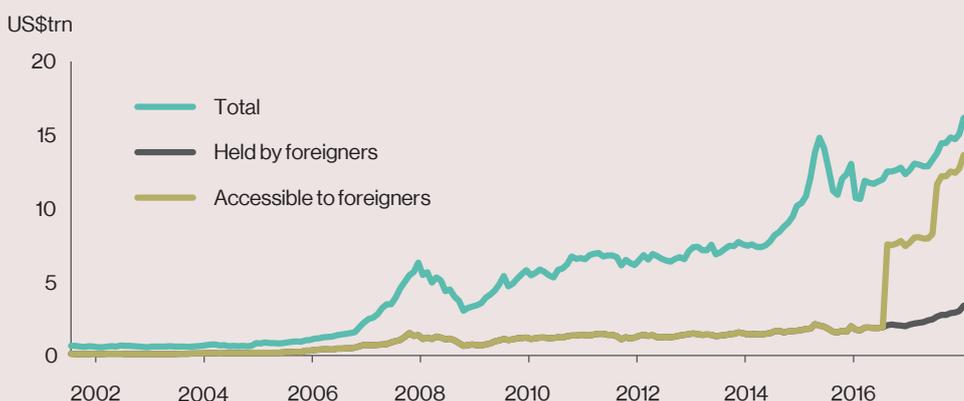


Figure 4 – Bond market (foreign holdings as % of total value of bond outstanding)



Source: "China's Bond Market and Global Financial Markets", IMF, 2018

Figure 5 – Size of onshore markets and their accessibility to foreign investors: (US\$trn)



Source: "Considering Chinese assets", Willis Towers Watson, 2019

2. Why does China want to open up?

China has been one of the biggest beneficiaries – if not the biggest beneficiary – of globalisation over the past four decades. From an economic standpoint, greater cross-border capital flows are believed to bring substantial benefits to its economy, including promoting financial sector competitiveness, facilitating greater productive investment and deepening domestic capital markets, which in turn further supports the economic development.

China's investor base is dominated by retail investors, with households owning more than 60% of the total (free float) equity market, according to [Bridgewater](#). Increasing foreign ownership is expected to lead to a higher proportion of institutional ownership. And that often results in more stable markets (less extreme swings in sentiment), as well as longer time horizons.

[Morgan Stanley](#) believes that China will likely face a sustained period of current account deficits, due to a number of drivers including transition to a consumption-led economy, a decline in savings and an ageing population. To finance the country's current-account deficit, China will need at least US\$210bn of net foreign capital inflows per year from 2019 to 2030, requiring the country's leadership to embrace a larger role for foreign capital to keep its balance of payments in check.

On the flip side, it has long been recognised that volatile capital flows in large size can pose policy challenges ([IMF](#)). Historical experience has shown that capital account liberalisation reforms can be accompanied by sudden reversals in capital flows, with large movements in the exchange rate and financial instability weighing on economic growth.

Despite its potential risks, the overall economic benefits seem to outweigh the costs.

Nonetheless, economic considerations only provide a partial understanding of China's motives for opening up. A more complete understanding requires appreciating China's geopolitical aspirations.

For most of [human history](#), China has been one of the world's dominant powers, until the industrial revolution in Europe and the US led to its relative decline. In China's history books, this period, starting from the First Opium War, is referred to as the "century of humiliation (百年国耻)".

The ruling Chinese Communist Party is committed to restoring China's great power, a message that resonates strongly with Chinese people. Under this backdrop, an internationalised RMB, as a, if not the, global reserve currency, and being home to the deepest capital markets that underpin world-class companies would be seen as adding to the country's geopolitical capabilities. Relaxing capital controls and attracting foreign capital to deepen capital markets are all part of a grand scheme to improve China's global standing. This geopolitical motivation should not be underestimated.

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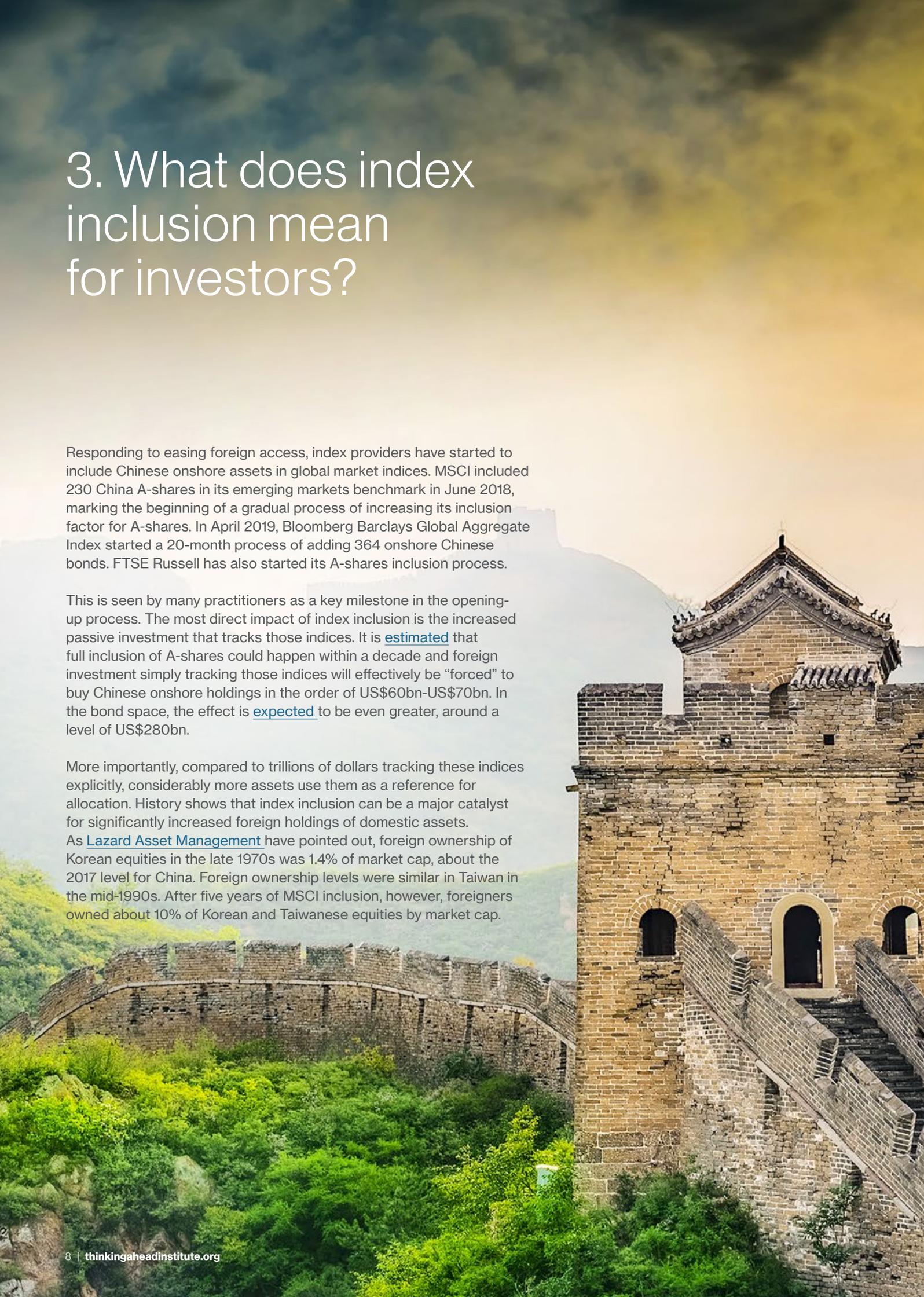


3. What does index inclusion mean for investors?

Responding to easing foreign access, index providers have started to include Chinese onshore assets in global market indices. MSCI included 230 China A-shares in its emerging markets benchmark in June 2018, marking the beginning of a gradual process of increasing its inclusion factor for A-shares. In April 2019, Bloomberg Barclays Global Aggregate Index started a 20-month process of adding 364 onshore Chinese bonds. FTSE Russell has also started its A-shares inclusion process.

This is seen by many practitioners as a key milestone in the opening-up process. The most direct impact of index inclusion is the increased passive investment that tracks those indices. It is [estimated](#) that full inclusion of A-shares could happen within a decade and foreign investment simply tracking those indices will effectively be “forced” to buy Chinese onshore holdings in the order of US\$60bn-US\$70bn. In the bond space, the effect is [expected](#) to be even greater, around a level of US\$280bn.

More importantly, compared to trillions of dollars tracking these indices explicitly, considerably more assets use them as a reference for allocation. History shows that index inclusion can be a major catalyst for significantly increased foreign holdings of domestic assets. As [Lazard Asset Management](#) have pointed out, foreign ownership of Korean equities in the late 1970s was 1.4% of market cap, about the 2017 level for China. Foreign ownership levels were similar in Taiwan in the mid-1990s. After five years of MSCI inclusion, however, foreigners owned about 10% of Korean and Taiwanese equities by market cap.



4. Is investing in China now as unrestricted as investing in developed markets?

The short answer is no, despite all the positive developments.

In terms of explicit barriers, while quotas are still in place for some inbound investment schemes, it is no longer a practical constraint. For example, Stock Connect imposes an aggregate quota for daily total purchases, currently at the level of RMB104bn, well in excess of average daily net purchases, according to GavekalDragonomics. For Bond Connect, the quotas have been completely dropped.

One of the very latest developments was announced by China's foreign exchange regulator in September 2019 and completely removed quota restrictions for Qualified Foreign Institutional Investors (QFII) – allowing foreign investors to use their home currencies to invest and Renminbi QFII – allowing the use of offshore Renminbi (CNH) to invest. But even before this move, the quota has rarely been fully utilised. In January 2019 China doubled the QFII quota to US\$300bn, but only US\$111.4bn of the limit had been used by foreign investors as at the end of August, according to [Reuters](#).

However, that is not to say that there are no longer market accessibility issues. For example, while Stock Connect has no lockup or restriction on repatriation, it only provides access to a subset of the equity market (slightly more than 1/3). On the other hand, while QFII and Renminbi QFII allow access to all securities listed on Shanghai & Shenzhen Stock Exchanges, its restrictions on repatriation and required lock-up periods are often mentioned as the reason for the quota not being fully used. In the A-share market, access to hedging instruments is still rather limited. The lack of listed futures and other derivatives products mean investors' ability to manage risk is constrained. According to [MSCI](#), many investors highlighted the need for a well-functioning omnibus mechanism, ie the ability to place a single order on behalf of multiple client accounts. It is seen as critical to facilitate best execution and lower operational risk for international institutional investors.

Looking forward, it is plausible that all these accessibility issues will be gradually addressed over time, at a pace that Chinese authorities deem appropriate.

“...while QFII and RQFII allow access to all securities listed on Shanghai & Shenzhen Stock Exchanges, its restrictions on repatriation and required lock-up periods are often mentioned as the reason for the quota not being fully used.”



5. How committed is China to the opening-up process? Might China re-close the door?

There is a concern among some investors that China might reverse its opening-up process which would hurt foreign investments in China. We don't have the ability to predict the future and therefore cannot rule out this adverse scenario completely. However, our central scenario is that this is unlikely to happen.

First, reversing the opening-up process is incompatible with China's long-term economic and geopolitical interest of re-claiming its status as a great global power, as argued earlier. Maybe the best way to understand the Chinese mentality on power building is via this expression: "The water that bears the boat is the same that swallows it up." (水能载舟亦能覆舟). China believes in supporting and maintaining a functional and highly connected global political and economic system that ultimately supports a rising power. It is hard to conceive that China would rather take an inward-looking approach to build its power.

"China believes in supporting and maintaining a functional and highly connected global political and economic system that ultimately supports a rising power."

Second, China has a four-decades-long track record of opening up that allows us to examine its behaviours. The blueprint was laid out by Deng Xiaoping at the very beginning of the opening-up process. The principle of "Cross the river by feeling the stones." (摸着石头过河) stresses gradualism above all. It means all changes and tactics have been and will be developed incrementally in small steps, that allow reversal if appropriate. In each of these efforts, the pace of change has been deliberately slow and measured.

This is exactly the playbook that China has been following over the last four decades. It is also consistent with the process followed by other nations before China. It is widely recognised that capital account liberalisation needs to be well planned, timed, and sequenced as volatile capital flows in large size can pose policy challenges. A 2018 Reserve Bank of Australia [study](#) summarised four broad themes that have characterised the Chinese approach:

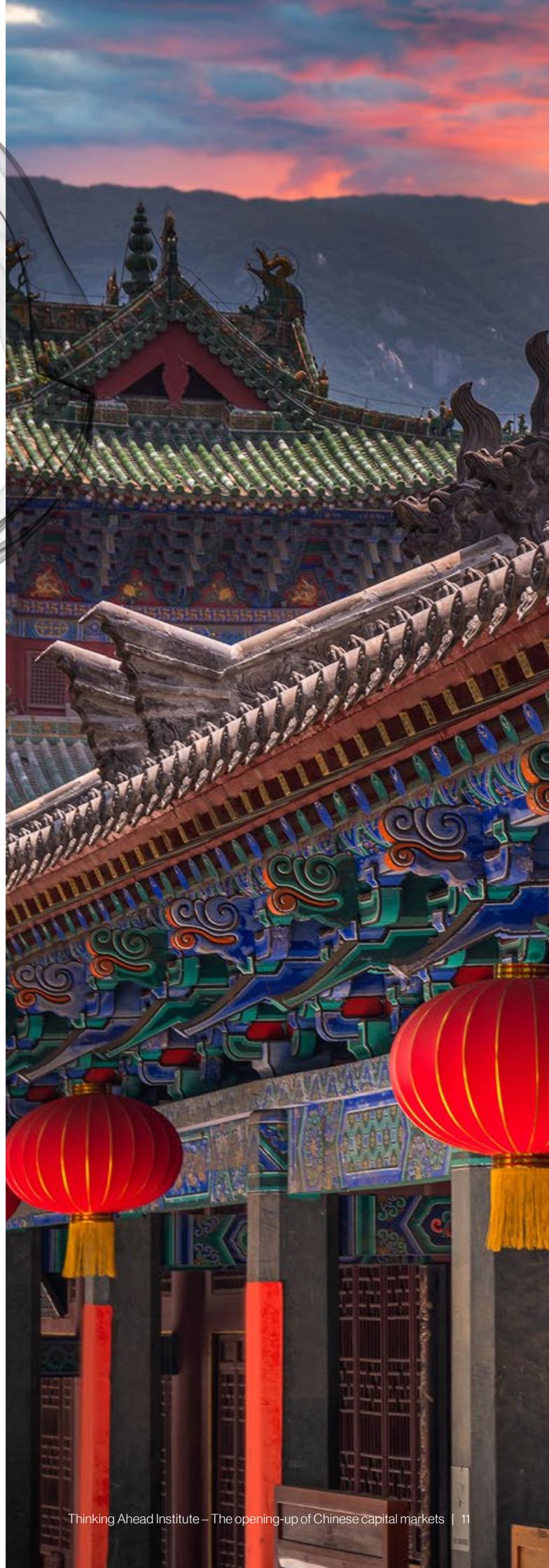
1. Policymakers have favoured liberalising capital inflows more than outflows to facilitate domestic economic development
2. Foreign direct investment (FDI), seen as longer-term and more stable flows, have been more liberalised than volatile portfolio flows to mitigate the risk of capital flight
3. State-owned enterprises have traditionally been granted greater freedom in their ability to undertake capital account transactions, compared to other types of investors
4. The authorities have shown a willingness and ability to alter the pace of liberalisation when they deem appropriate.



The last point is worth emphasizing. Examples include the Asian financial crisis in the late 1990s or the 2008 global financial crisis when capital outflow and financial stability concerns were heightened. The latest episode started in late 2014 when China's growth outlook had weakened and almost US\$1trn in private capital flowed out of China between 2014 and early 2017. The authorities responded to capital outflows by pausing the process of capital account liberalisation. New controls on capital outflows were implemented and existing controls were enforced more stringently. This was seen as a major setback for the renminbi internationalisation.

While the pace of the opening-up has been often used by Chinese policy makers as a lever to manage the process and a tactical response to adverse economic situations, there is very little evidence suggesting the direction of opening-up has been or will be reversed. We believe that China doesn't take lightly its commitment to the opening-up process.

"It is widely recognised that capital account liberalisation needs to be well planned, timed, and sequenced as volatile capital flows in large size can pose policy challenges."



6. Why do western investors want to own Chinese onshore assets?

So far, we have focused on addressing the supply of Chinese assets, which become increasingly accessible due to the opening-up process. For the “accessible” to become “invested”, we will need to examine the demand side of the story. What is the investment case for owning Chinese onshore assets in a global portfolio?

There is probably a very long list of reasons why a diversified global portfolio should have some Chinese onshore exposure. Some are more important than others. Our thesis is based on three main pillars: (1) a strong long-term diversification benefit (2) plenty of headroom for active management to exploit market inefficiencies (3) as a hedge for a new world order.

While we can easily find historical [data](#) to show that Chinese assets have had a low correlation with the rest of the world in both equity and bond returns, it is more important to understand the fundamental drivers of that low correlation and whether it will persist.

The Chinese economy is driven by a number of diverse forces that are particular to this marketplace, therefore providing a strong long-term diversification benefit to outside investors. Here we list a few of the prominent drivers:

- One of the most dynamic forces driving China’s growth is the rise of its domestic consumer, of which a majority is categorised as middle class. [McKinsey](#) expects more than 75% of its urban consumers to be in that category by 2022. In 2018, China’s leadership reconfirmed its commitment to transition the country to a consumption- and services-driven growth model over the next 10 years and steady progress has already been made ([P&I](#) reported that the contribution of domestic consumption to GDP growth in China has moved from less than 50% in 2013 to around 80% in the first nine months of 2018)
- China’s consumers have their own specific set of preferences (see more in this [WEF and Bain](#) report). For example, they are rapid adopters of internet-based and mobile services. China racked up US\$9trn in mobile payment transactions in 2016, 80 times the US level ([Bain](#)). Many are already accustomed to paying for access rather than ownership and will prefer premium and personalised products and services

- Having been a major manufacturing power in past decades, China is on the path to become an active leader in digital and other technological innovations (see this [Wellington piece](#) on China as an innovation superpower). This is supported by a deep pool of skilled labour – China has almost six times more computer science graduates than the US ([Bain](#)).

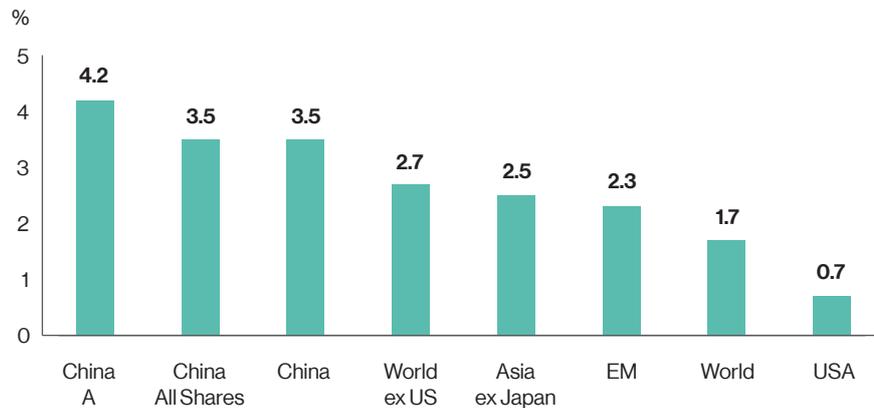
Chinese capital markets are less developed compared to its western peers, creating many challenges for investors. Sometimes huge price swings have made China’s stock market seem like a casino. While having made [meaningful progress](#), its corporate governance practices are often criticised as a major weakness. China is certainly not known for its world-class enforcement of contractual obligations, regulatory quality and respect for intellectual property rights.

But challenges and opportunities are really just two sides of the same coin. The less efficient nature of the financial market means China is ripe for active management. For example, the median active China A-share manager’s excess return was 5.7% pa (10 years ending in 2019), more than four times the excess return of the median active EM or ACWI manager ([BlackRock](#)). It has also been more rewarding for factor-based strategies including ESG considerations (see charts overleaf from [MSCI](#)) compared to other more developed markets as these factors are not (yet) priced in (Figure 6).

There is an even better news: the dominance of retail investors means active management does not necessarily have to be a zero-sum game for institutional investors!

“While we can easily find historical data to show that Chinese assets have had a low correlation with the rest of the world in both equity and bond returns, it is more important to understand the fundamental drivers of that low correlation and whether it will persist.”

Figure 6 – Historical annual factor premium (%)



Last but by no means least, we are living in a historical period where the global economic domination is potentially shifting from the US to China. As [Martin Wolf](#) from the Financial Times argued, other things being equal, population is decisive in determining the size of an economy. The US has the largest economy mainly because it has the largest of all population of high-income countries, by far. The population of China is, of course, far larger.

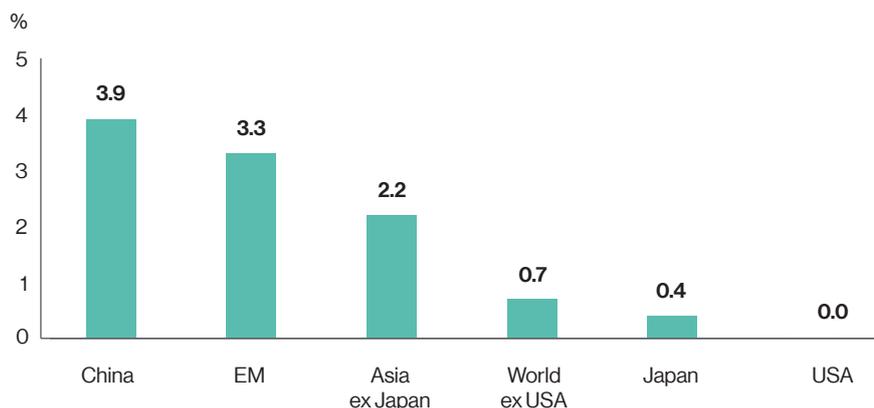
China's rise to becoming a global superpower is not an inevitable outcome, as China has many challenges to address. However, most would agree that this is a plausible, if not probable, outcome.

So where does this leave investors?

We would suggest simply going back to the principle of “don't put all your eggs in one basket”. Within the MSCI ACWI index, China currently has a 4% weight (mostly offshore assets) while US has a weight of 55%. And active equity funds tend to be underweight China even relative to this very small weight ([MSCI](#)).

This is not an allocation positioned for a possible tectonic shift in global economical and geopolitical order. This is a business-as-usual allocation. Investors ought to examine whether their investment allocations align with their beliefs on this particular matter.

Figure 7 – Historical annual ESG premium (%)



7. What are the risks and challenges?



There is a joke that a foreigner needs to have a “PhD in China” to navigate different facets of Chinese capital market development which for the better part of its history has been isolated from and hence not well understood by the outside world. This lack of understanding presents the first challenge to many investors looking to allocate to China.

There are no doubt risks associated with investing in China. In our view, one of the important risks, although not frequently discussed, is to do with the fact that China’s capital account liberalisation policy has so far been asymmetric, favouring capital inflows more than outflows. This could mean that both domestic and foreigner investors end up competing for the same set of assets, potentially bidding up prices beyond what can be justified by fundamentals.

For example, in September 2019 when China’s foreign exchange regulator scrapped quotas on inbound investment schemes, it made no move to ease restrictions on the outbound scheme. Admittedly, schemes like Stock Connect and Bond Connect aim to facilitate two-way investment flows. But the Chinese authorities have in the past shown that they would not hesitate in addressing large-scale capital flight while providing steady support to inbound investment liberalisation.

Whether this risk materialises or not of course depends on the Chinese economy’s ability to productively absorb the extra supply of capital. It is a huge economy still growing relatively fast, so the new capital doesn’t necessarily have to end up in “building bridges to nowhere”. But from an investment ecosystem perspective, we believe that blockages – in this case capital doesn’t flow freely on one direction – cause tensions and without relieving mechanisms they could cause disruptions.

Many investors have legitimate corporate governance concerns in relation to Chinese companies. Numerous companies have a reliance on government subsidies and the quid pro quo is that their decision-making is subject to arbitrary government interference.

Related to the corporate governance issue, according to [GMT Research’s data](#), the risk of accounting fraud for companies in China is multiple times higher than that of global companies. Chinese companies with repeated losses receive “subject treatment” (ST) by regulators, which are more closely supervised by auditors and regulators, making them less attractive to investors. This suggests an incentive for companies in distress manipulating their earnings in order to avoid special treatment.



Another important risk is liquidity related. For example, it is fairly common for trading to be halted before certain important announcements. A circuit breaker rule is in place that halts trading of stocks when prices move up or down by 10%. When the entire market is in stress, a large segment of companies can breach this limit, creating a severe liquidity shortage. Stock suspensions have also caused liquidity issues. During the Chinese market sell-off of mid-2015, it is reported that approximately 1,200 out of 2,800 listed companies applied for voluntary suspension ([BNP Paribas Asset Management](#)). Policymakers have sought to address this particular issue since then.

When it comes to investing in China, some investors not only worry about the return on their capital but also the return of their capital, reflecting a concern that the Chinese authorities might unilaterally decide to reverse the opening-up process and cut the country off from the rest of the world once again. We have addressed this particular risk in question 5.



8. So, what is the final verdict? Do opportunities outweigh risks and challenges?

China's opening-up process has entered a new era of embracing western institutional investors. A large, and still increasing, part of the equity and bond markets have become accessible. Over the next decade and beyond, it is entirely conceivable that global investors will add trillions of dollars of Chinese onshore assets into their portfolios.

Simply put, the opening-up of China is likely one of the biggest changes to the investment opportunity set global investors will witness in their lifetimes. How do we, as investors, ride out this great shift?

Ultimately this is a question that investors will have to answer themselves but, in the spirit of trying to be helpful, we conclude this paper with three thoughts:

- First, if your return-seeking portfolio doesn't have any exposure (or very little) to China you should add it to the agenda of your next investment committee meeting to review whether your allocation is consistent with your circumstances, investment beliefs, risk / return / impact assessment and the rapidly-changing Chinese investment environment.

- Second, don't rush to buy China just because everyone else is doing so. This is a strategic move, not a tactical one. And be aware of market disruptions due to herding behaviours.
- And last, when assessing risks and portfolio sizing, guard yourself against the omission bias. Omission bias is the tendency to favour not doing something over doing something that might go wrong. In this case, investing in a foreign country where the governing structure and value system are substantially different, investors may consider it safer to underweight their allocation, contrary to what the economic fundamentals actually warrant.

The sheer size of China's economy and its expected trajectory means the potential costs of omission bias could be big. A global shift of this magnitude might only come once in our lifetime.

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“Simply put, the opening-up of China is likely one of the biggest changes to the investment opportunity set global investors will witness in their lifetime.”



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Limitations of reliance – Thinking Ahead Group 2.0

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The Thinking Ahead Institute

About the Thinking Ahead Institute

Mobilising capital for a sustainable future.

Since establishment in 2015, over 60 investment organisations have collaborated to bring this vision to light through designing fit-for-purpose investment strategies; better organisational effectiveness and strengthened stakeholder legitimacy.

Led by Tim Hodgson, Roger Urwin and Marisa Hall, our global not-for-profit research and innovation hub connects our members from around the investment world to harnesses the power of collective thought leadership and bring these ideas to life. Our members influence the research agenda and participate in working groups and events and have access to proprietary tools and a unique research library. They have also helped form our top ten investment beliefs.

1. Economies and markets are complex adaptive systems, requiring different thinking
2. Sustainable value creation starts with purpose. It can, and should, be measured and communicated. Integrated Reporting is a transparent and effective method
3. A new interpretation of sustainability is needed to advance a better social purpose in the investment industry
4. Long-horizon investors have a significant advantage because there is a quantifiable premium
5. Climate change will significantly affect investments
6. The asset classes of tomorrow will be substantially different
7. The returns you need will only come from a system that works
8. Pensions are worth more in a world worth spending them in
9. Culture is a unique ingredient in gaining a competitive advantage and effecting change
10. Collective decision-making is a skill that can be developed.

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We seek collaboration with like-minded organisations to achieve our vision, so for more information about us please contact:

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The Thinking Ahead Institute seeks to bring together the world's major investment organisations to mobilise capital for a sustainable future. Arising out of Willis Towers Watson's Thinking Ahead Group, formed in 2002 by Tim Hodgson and Roger Urwin, the Institute was established in January 2015 as a global not-for-profit group comprising asset owners, investment managers and service providers. Currently it has over 40 members with combined responsibility for over US\$12trn.

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