Asset classes of tomorrow: China – 15 June, 2021

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Agenda

- Building a strategic case of why China is set to become an increasingly important part of global portfolios over years to come
- Willis Towers Watson China research priorities
- How Willis Towers Watson is engaging with clients on this topic and how we are addressing the typical challenges.

Summary of talking points

- Liang started the conversation by giving an overview of TAI's Asset classes of tomorrow: China research which covers the investment potential of these capital markets for institutional investors. That research was three years ago and now WTW is recommending building up allocations to China in the region of 20% of the growth portfolio by 2030. Follow the rationale on pages 1-7 of the presentation deck or read this published article
- Now that WTW client allocations have started to flow (c. US$2bn in listed equity alone) there is a need to become more focused and strategic, which involves looking beyond listed equities, bonds and private equity to the likes of real assets and hedge fund
- In order to make this transition WTW is ideally looking for asset managers who 1) come from a Chinese background, and 2) have some overseas education and work experience. The rationale is to back managers who understand China's economy, politics and market dynamics while having exposure to global investment management best practice. This would include both global and local organisations.
- These investment organisations are likely to fall into three categories:
    - Local mutual funds (which may have less sustainability of skill)
    - Private fund settings which resemble Western-style hedge funds, but can be long only and charging 2&20 - although better fee deals can be negotiated
    - International houses with a local presence defined by nurturing local talent, having strong international controls and oversight with a global operating model.

- While there are advantages in this market, there are also concerns over capital controls, liquidity, sustainability and other types of frictions. These frictions can be misunderstood. It is in the interests of the Party and the Chinese economy to maintain the good track record around *opening up* – which started four decades ago - to continue. In the past four years it has actually accelerated and there has been continued easing around foreign investment. There is no indication from the Party that the *opening-up* policy will change and combined with the continuing integration of global capital markets indicates inward flows are likely to continue growing.
- In addition to restrictions to investing in China by some countries, there are also perceived concerns that doing so will strengthen a geo-political rival. Yes, there are some disruptive end scenarios, but somewhat like the USA / USSR rivalries of the past, the concern around potential mutual damage tends to influence the course of events and relationships more than other factors. That said the whole thesis around the US / China rivalry needs to be regularly revisited.
- While predicting demand from pension funds for Chinese assets is difficult, there is a trend developing towards bigger, more strategic allocations. These allocations are seen differently to other emerging markets, and as unique diversifiers in geographically concentrated portfolios.
- What are the opportunities in Chinese fixed income? Accessibility is no longer a restriction and there are opportunities in sovereign bonds. For the corporate credit market, there are concerns about liquidity, sub-standard credit analysis and unreliable ratings (95% are rated AA and above).
- Do China A shares present a good risk / return opportunity in the context of emerging markets and is allocation increasing? WTW's delegated clients are making larger allocations, in the order of 12%, including from US funds. In terms of China A vs all China mandates, it was noted that the biggest gap in portfolios is the onshore exposure hence the first stop of many asset owners' China strategy is a China A allocation
- There is a strong *brown to green* philosophy in China and an extraordinarily rapid rise in ESG disclosures from Chinese companies.
- It is important to recognise risks such as operational, legal, reputational, and financial risks can indeed arise from human rights issues and it is a global challenge, not unique to China. Investors need to conduct their due diligence properly and seek to understand the risk exposure in this regard. That being said, investors are reminded not to take the Western media view of China as fact, particularly the myth that investing in China = supporting the Party. Also that Western values are somehow Universal values. There is also the myth that one can divest from China, in fact it is really not possible given *Made in China* is found in most parts of most economies globally.
- There is a sense that blanket bans from investing, while perhaps providing 'good' optics are generally blunt and ineffective. Whereas collective engagement on a case-by-case basis is more effective in influencing the direction of travel.
- There is an ESG momentum developing in China, but it needs to be seen not solely from a Western perspective
- Investment in US treasuries vs Chinese sovereign bonds. Regarding the latter, it could be seen as supporting the Party but equally could be seen as investing in a broad range of important areas: development of infrastructure, housing, health care and lifting 850 million people out of poverty in the past few decades. Regarding the former, from an ESG perspective, investors would have similar reservations, if this were an emerging opportunity now. As it is, US treasuries are already in the portfolio and 'trapped' by omission bias.

About the Thinking Ahead Institute

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