

# Avon Pension Fund

## Investing in Chinese equities

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welcome to brighter



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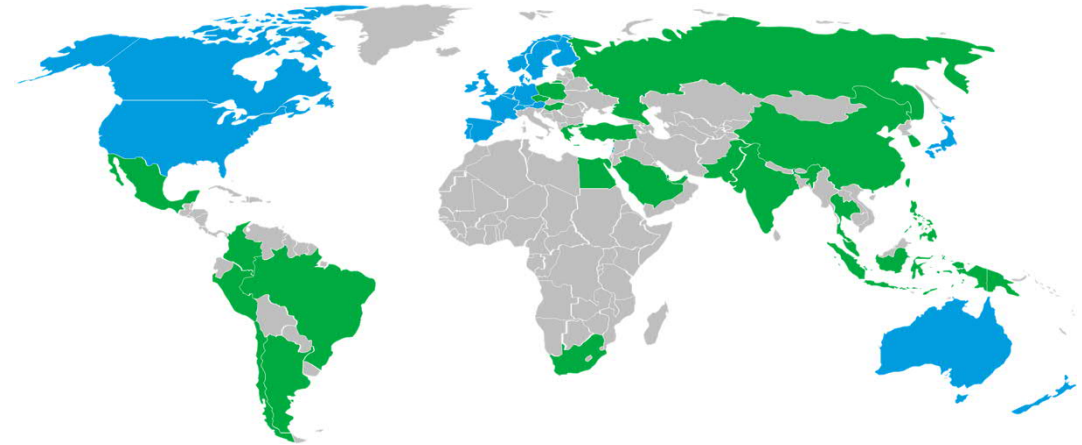
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# Summary

- This presentation is addressed to the Pension Fund Committee (“the Committee”) of the Avon Pension Fund (“the Fund”) and considers the role of Chinese equities within the Fund’s strategy. This presentation is for information purposes and aimed to facilitate discussion amongst the Committee, and does not contain any recommendations.
- As at 31 December 2020, the Fund’s exposure to China was 5% of the equity portfolio (c.2% of total Fund assets), which is in line with the global market cap index weight. This exposure is gained via the Brunel Emerging Markets Equity fund, the Brunel High Alpha Fund and the Brunel Global Sustainable Equity Fund.
- All three of these funds that invest in China are actively managed, hence holdings in particular Chinese stocks are based on manager conviction, rather than purely due to the stocks’ inclusion in the index.
- From a pure investment perspective, investing in Chinese equities is expected to provide attractive long-term returns and diversification benefits. However, there are wider ESG and geo-political risks to consider. This is a key reason why we strongly prefer an active management approach; we see this as the best way of taking such issues into consideration.
- The Panel is currently reviewing the structure of the Fund’s equity portfolio, which includes consideration of the allocation to emerging markets (and hence China) in light of the significantly higher contribution to carbon emissions from emerging markets relative to developed markets. A key issue that the Panel will keep in mind is the need to maintain the expected return from the equity portfolio given its role as the largest contributor to the return of the Fund’s assets.

# Why allocate to emerging market equities?

- “Emerging” markets are typically smaller, economically, with equity markets that do not meet the size/liquidity and/or market accessibility criteria of developed markets.
- We typically recommend investors make an allocation to emerging market (EM) equities given the breadth it provides, associated diversification benefits, and potential for higher long term returns.
- This can be done on a “standalone” basis, or as part of a broader global mandate (provided the exposure is truly global).
- Within emerging markets, higher returns are primarily expected from higher active management potential (due to greater market inefficiencies) and higher risk. Diversification benefits should reduce the impact of EM equity's higher volatility/risk on total equity portfolio risk.
- We believe that a strategic allocation to EM equities (including China) — at higher weights than represented in MSCI AC World Index (~12%) up to ~25% — can enhance long-term returns, portfolio diversification, and better reflect the global economic backdrop.
- However, this won't be appropriate for all clients, especially where Climate Change risk and other ESG issues are potentially key considerations.

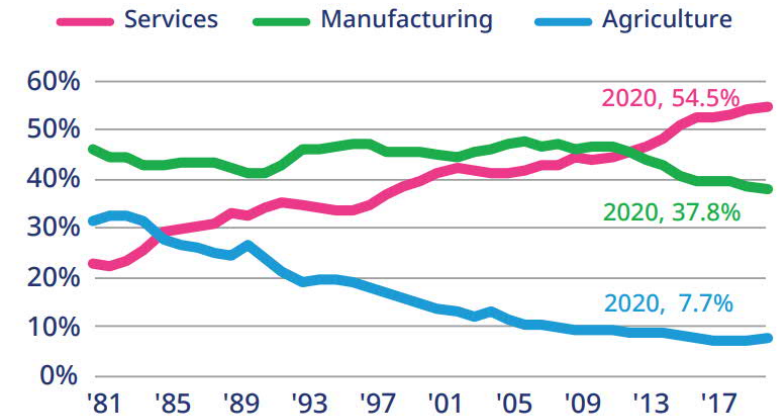


Emerging markets are shaded in green, developed in blue, grey is not classified.  
Source: MSCI.

# China – too big to ignore

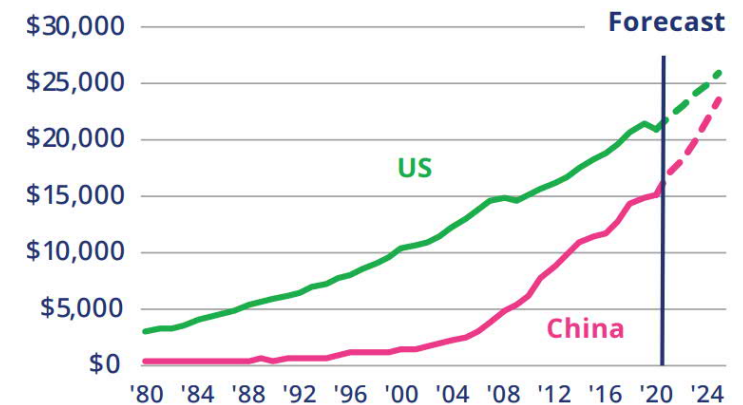
- China has outgrown most major economies over the past couple of decades and is expected to continue to do so for some time.
- Since 2000 China has tripled its share in global GDP and overtaken Japan as the second largest economy in nominal GDP terms. It now drives a significant portion of global GDP growth.
- Over the past 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, industrial automation, renewable energy, biotech and software.
- The rise of China over the coming decades could underpin unique economic and corporate growth drivers that we believe investors should have exposure to in equity portfolios. However, there is a clear balancing act to get the best exposure, between the positive return and diversification benefits, and the negative impact of ESG issues.

Share of Chinese GDP by sector



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

GDP size of China and US



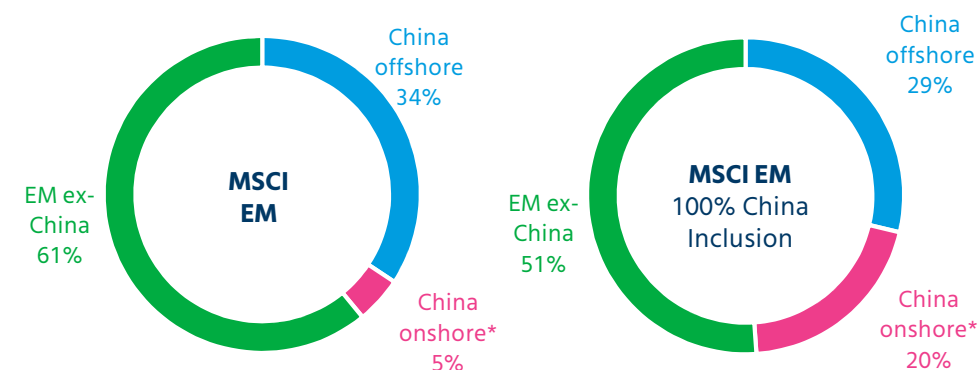
Source: IMF. GDP size, billions, current prices, US dollars. As at December 31, 2020.

# What is so unique about the Chinese equity market?

- The EM space has evolved significantly over the last two decades. The once broadly distributed MSCI EM index is now far more dominated by China, while ironically still not fully representing China's market.
- Chinese equities come in many forms but can be categorized in two broad groups:
  - Offshore shares:** easily accessible to global investors, primarily shares listed in Hong Kong/US.
  - Onshore shares:** mainland-listed, primarily A-shares, increasingly accessible to foreign investors.
- MSCI EM's China exposure is dominated by offshore shares (blue segment of left pie chart), because the onshore A-share market is represented at an inclusion factor of 20%. Onshore exposure will increase as benchmark providers move towards full inclusion of A-shares (right pie chart), but the timing is uncertain.
- In our view, there is an argument for adjusting portfolios to achieve a broader strategic exposure to China's equity opportunity set without waiting for changes to the index.



Source: FSSA Investment Managers, Hong Kong Exchanges and Clearing, NASDAQ, as at December 31, 2020.



Source: MSCI, as at December 31, 2020.

\*China A-shares constitute the majority of China's onshore equity market.

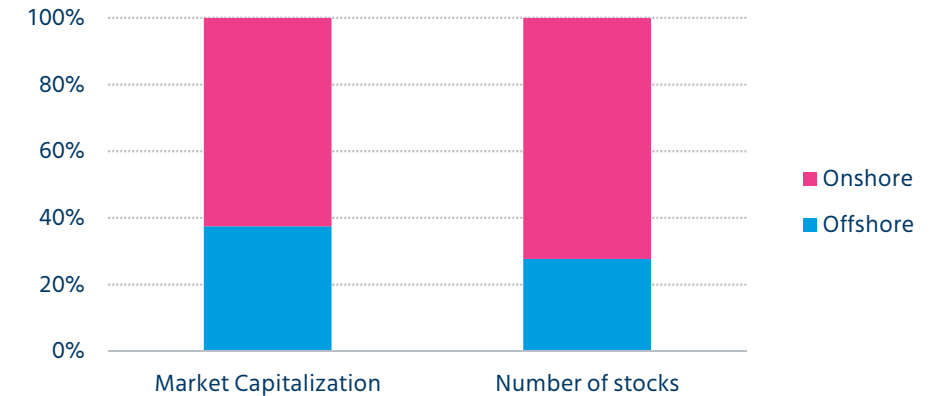
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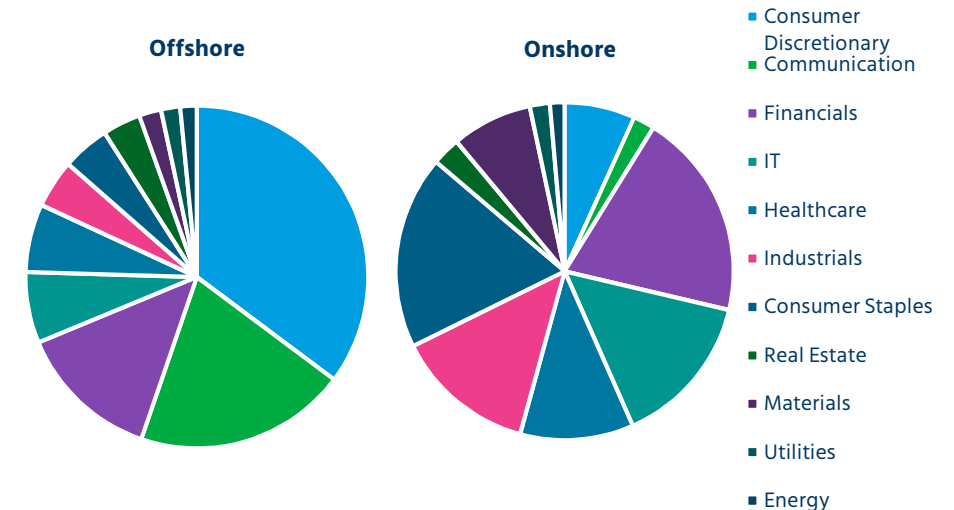
# Why should investors have a broader allocation to China?

- China's onshore market is larger than the offshore market by market capitalisation and number of stocks.
- The onshore market is tilted more evenly across areas of future domestic consumption, and provides access to economic segments not well represented offshore, such as leisure, food and beverages, media, and areas of technology. It is also more balanced across market capitalisation size bands, while offshore shares are dominated by mega caps.
- The offshore market also provides important exposure to China, but is more concentrated in a few sectors and stocks.
- China's policy agenda is increasingly focused on domestic consumption, innovation and high value-added segments like tech/healthcare. In a New World polarized between competing powers, critical economic and corporate growth exposures may only be fully accessible via the onshore market.
- There is merit in considering a broader and more representative allocation to China that incorporates higher strategic exposure to the onshore market.

Greater onshore opportunity set...



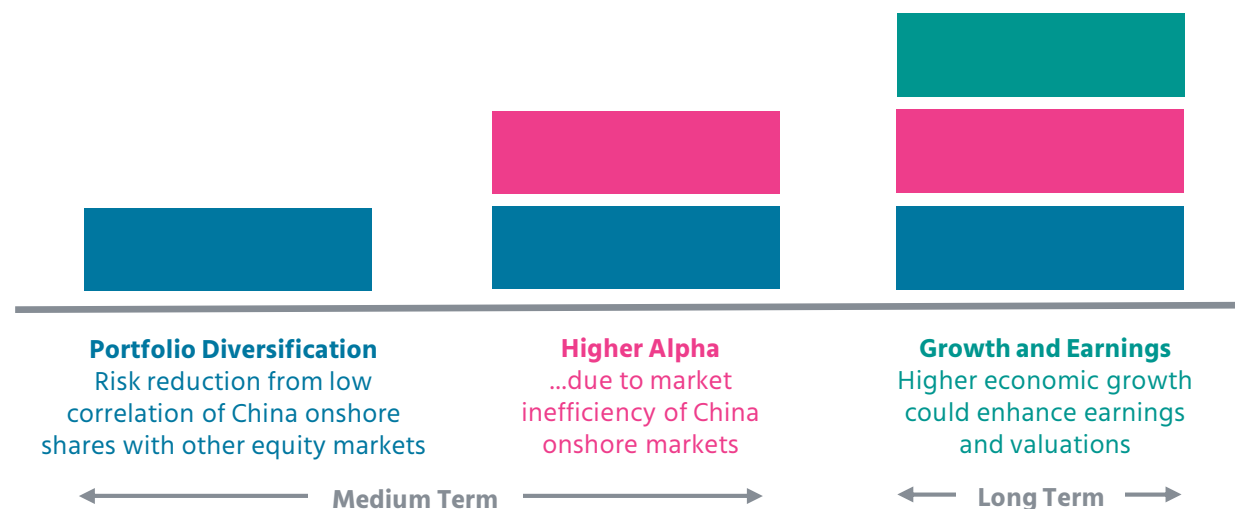
...and more diversified and reflective of China's future



Source: (Top chart) FSSA Investment Managers, Hong Kong Exchanges and Clearing, NASDAQ, as at December 31, 2020. (Bottom chart) MSCI. As at December 31, 2020.

# Portfolio benefits from having more onshore

- Broader China allocations in equity portfolios with both **offshore and onshore** market exposures can help to address current typical underexposure to the onshore market.
- Higher structural exposure to the onshore market (A-shares) adds value to portfolios in three ways:
  - **Diversification:** lower correlations with other equity markets due to China's unique economic, corporate and political backdrop.
  - **Alpha:** more opportunities for skilled active managers as a high degree of retail investor participation makes the market less efficient.
  - **Growth:** a potentially positive supplemental factor rather than a key reason to invest, as the relationship between economic growth and equity returns is uncertain. But broader access to China's growth reinforces longer-term diversification benefits.





# What China-specific risks should investors consider?

- While higher returns and diversification benefits can **compensate** investors for ESG risks, and actively-managed strategies with strong ESG focus can help **mitigate** these risks, investors should be mindful of the following:
  - In spite of improvements over the last decade, corporate governance in China is still an issue; foreign investors enjoy limited protection and shareholder dilution has been problematic in the past.
  - 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. This may still impact some investors' appetite for China exposure.
  - **China is the highest carbon emitting economy in the world**, but is also investing heavily in industries to support transition to a cleaner economy. During 2020, China explicitly stressed environmental objectives such as “Beautiful China”, 2060 net carbon neutrality and green development funding.<sup>1</sup> Whilst China faces medium term transition challenges, it could also be a good long term bet on energy transition.
  - As demonstrated by Trump's Executive Order (EO) in November 2020 (see our [article](#)<sup>2</sup> for details), political risk and sanctions can directly impact allocations to China. Barring a major event such as China invading neighboring countries, we see targeted measures (such as banning investment in companies directly linked to the Chinese government and its military, in particular) as more likely than a blanket ban of investing in China.
- These risks should not be underestimated, but they are manageable with active management.

<sup>1</sup>[http://english.www.gov.cn/statecouncil/ministries/202010/29/content\\_WS5f9a019dc6d0f7257693e947.html](http://english.www.gov.cn/statecouncil/ministries/202010/29/content_WS5f9a019dc6d0f7257693e947.html)

<sup>2</sup><https://www.mercer.com/our-thinking/wealth/ban-to-us-investments-in-firms-linked-to-chinese-military.html>



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