Willis Towers Watson

Considering Chinese assets

A valuable portfolio building block?

For Professional and Institutional Investors Only

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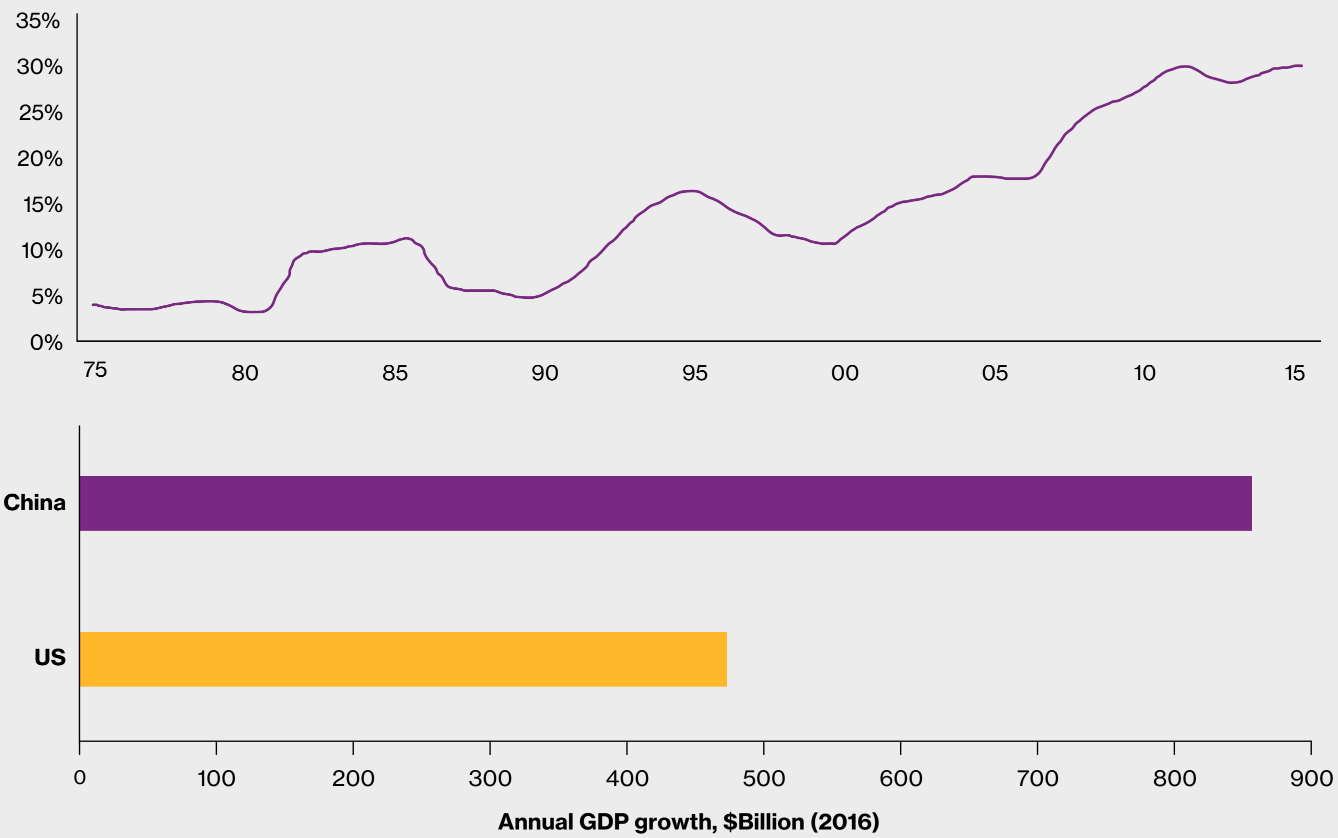
Bottom line

We believe institutional investors should consider an allocation to Chinese assets as a building block within their portfolio[1]. Instead of following index allocations, investors should consider the pros and cons of making an allocation to Chinese assets within their portfolio in the same way that they do with other markets. That is, investors should consider what risk premia are on offer and at what level of risk. As with all investments, we define risk broadly including a consideration of sustainability related factors. Whilst the case for allocating capital to Chinese markets will vary over time, we believe that Chinese assets offer compelling diversification benefits to typical investor portfolios from a strategic view.

Introduction

China is one of the world's most dynamic economies. Measured in many ways China's importance on the global stage is expanding. Be this through its contribution to the global economic growth, its share of commodity market demand or through its increasing political impact (trade wars, international relations), China is a major global player (see Box 1 on page 5 for more details). As a result China is at the centre of many of the world's 'megatrends'[2] and impacts global financial markets in many, often complex, ways.

Figure 1: **China's contribution to global GDP growth in absolute terms and as a proportion of global growth (market exchange rates)**



Source: World Bank, Willis Towers Watson

1. Note: In this paper we discuss Chinese assets in their broadest sense, including onshore and offshore markets. On occasions we refer to specific parts of this market. At these times we attempt to be clear with our definition.

2. For further information on megatrends, please refer to page 8.

Of particular importance to international investors is the process of liberalising the nation's capital account. Since its accession to World Trade Organisation status in the mid-1990s China has been integrated in global trade. However, its onshore financial markets remained controlled and effectively closed to international investors for many years until the early 2000s. 'Opening up' accelerated with the announcement of the 12th Five Year plan in 2011. The plan made capital account and asset market reform a key goal of Chinese authorities (see Box 2 on page 6 for an overview of onshore Chinese capital markets).

What does this mean for international investors?

Over the past seven years authorities have taken steps to ease international investor access to onshore Chinese capital markets. Whilst progress has been deliberate and cautious and infrastructure remains nascent, the process of 'opening up' now means that international investors can access a new set of financial assets that were previously not part of their opportunity set. To put the change in context, the process is the largest since equivalent capital account liberalisations in mainland Europe and Japan in the mid-1980s and early 90s.

Where MSCI leads others will follow

Several programmes now exist to allow international investors to purchase Chinese onshore assets (see Box 3 on page 7 for more details) and as a result major liquid index providers have announced intentions to add these assets to their benchmarks alongside offshore equivalents.

MSCI was the first provider to announce onshore inclusion into its equity indices in May this year, with an initial factor of 2.5% of free float that will rise over time.

At the end of September 2018, Chinese equities (on and offshore) comprise approximately 3.4% of the total large capitalisation equity universe. Using current market sizes China may represent up to 5.5% of these indices by the time the MSCI inclusion process is finished (or nearly 40% of emerging market exposure).

Other providers are following suit. FTSE Russell has also announced index inclusion in its equity indices in recent months. Whilst on the bond side Bloomberg Barclays has indicated that Chinese onshore government and policy-bank bonds will be included in its Global Aggregate index from spring 2019 (where assets may make up as much as 5-6% of the index following full inclusion).

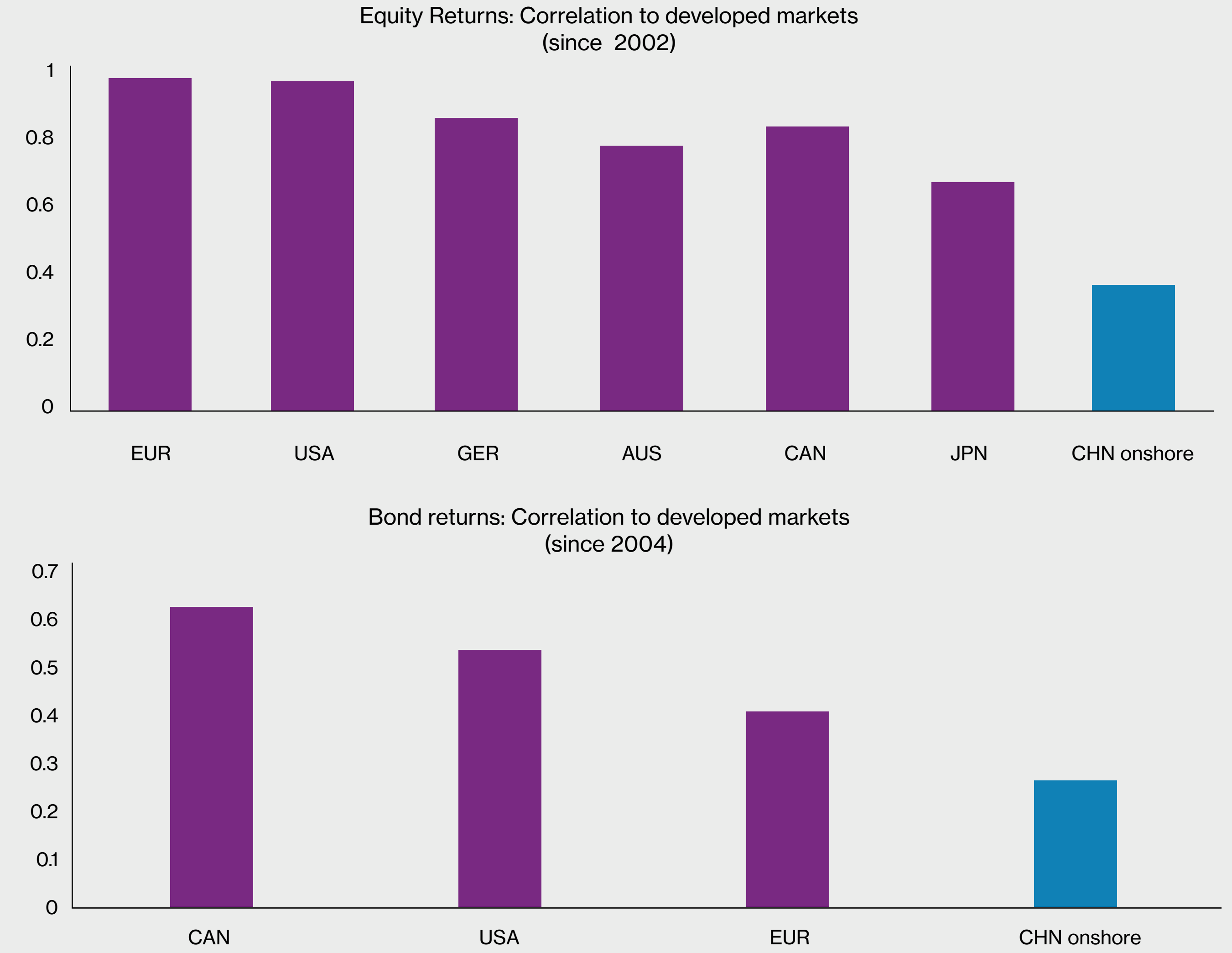
Whether investors view their portfolios on an absolute basis or relative to benchmark indices we believe that the opening up of Chinese onshore asset markets warrants further investigation. Investors should consider whether they wish to exclude Chinese assets from their portfolio, follow benchmark inclusion or take an alternative path.

When should investors incorporate Chinese assets into their portfolio?

Quite simply we believe investors should allocate capital to Chinese assets when their inclusion provides a portfolio efficiency improvement (return and/or risk) once all the pros and cons of adding an allocation are weighed against each other. That is, investors should consider the benefits of adding an allocation (risk/return) against the increased level of complexity in their portfolio, governance requirements, exposure to additional tail risk events etc.

On an empirical basis, Chinese assets have historically exhibited significant diversification benefits relative to other global markets as shown by their low correlation.

Figure 2: **Equity and bond return correlations have been low**



Source: MSCI, Bloomberg LP, Willis Towers Watson

On a forward looking basis greater integration in global capital markets is likely to lead to more co-movement in Chinese asset prices with their peers. However, in our view, Chinese assets offer access to cashflows that are linked to an economy that that provides fundamentally diverse drivers of cashflow generation such as the expansion of the large Chinese middle class (see *Figure 3*).

Will Chinese assets provide investors with an acceptable level of risk premia?

Diversification is only part of the story. Ultimately, investors require a reasonable return, relative to risk taken in order to hold an asset in their portfolio. Here our definition of the risk and return trade off is broad and includes an incorporation of sustainability (both micro level considerations, such as governance standards and macro level, for example human rights/market interference).

One of our core beliefs is that global asset returns reflect the outcome of cashflow generation relative to what was expected and investors' changing perceptions about the likelihood of future cashflow outcomes. We believe Chinese assets are no different from their global counterparts and there are few reasons that they shouldn't offer a reasonable set of risk premia, conditioned on pricing at any point in time. Therefore, we believe investors should consider all Chinese assets as part of their strategic opportunity set. Assuming asset pricing is reasonable we expect an allocation to Chinese assets to materially improve investor portfolio efficiency.

What are the risks and can they be mitigated?

We can think about the risks to Chinese asset returns in two broad categories: economic/financial and political, noting that sustainability-related risks fall under both.

Firstly, the risk of economic/cashflow generation underperformance can be somewhat mitigated through asset diversification, both within China and outside. Holding a portfolio of high quality Chinese bonds, equities and other assets provides material diversification benefits and is likely to smooth returns. However, a diversified beta portfolio still underperforms expectations when asset risk premia rise as a whole. Investors should be wary of buying Chinese assets when premia appear to be low across the board.

As noted above, sustainability related risks generally come in two formats. Micro risks related to an individual company or security, with examples such as poor governance standards, weak disclosure in accounts or weak investor rights. Investors should consider their ability to accept or influence these risks. Macro related risks, such as human rights, are perhaps harder to quantify in terms of their impacts on Chinese asset outcomes. However, investors should consider their level of concern, not least around the reputational aspects of an investment in Chinese markets.

Political risks are perhaps more difficult to quantify and avoid. The ultimate risk is a confiscation of capital, alternatively a tightening of capital outflows that impacts international investors would also materially impact investor outcomes. We believe this risk to be small. However, as above, investors may wish to limit overall exposures to Chinese related assets whilst institutions strengthen over time.

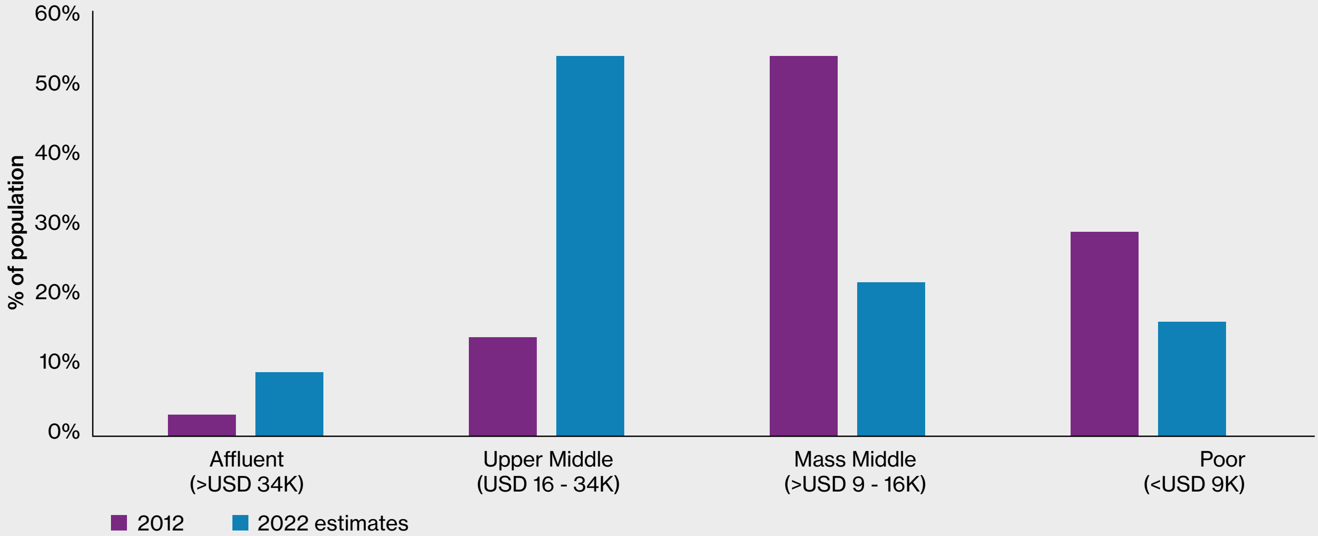
Finally, other risks such as implementation, taxation, asset selection and idiosyncratic asset issues can be somewhat mitigated through the selection of appropriate asset manager partners.

What solutions are available for investors?

We are working on several solutions that will allow investors with differing beliefs and governance capabilities to invest in a diversified portfolio of Chinese assets. These solutions cover the spectrum of active management, smart beta and bulk beta and are structured with our best in class philosophy in mind. Our experience (over 20 years) and expertise in the region mean that we have a network of contacts that we are able to work with in order to bring leading edge invesment ideas. If you are interested in finding out further information about our work, please contact your consultant.

In our view, Chinese assets offer access to cashflows that are linked to an economy that that provides fundamentally diverse drivers of cashflow generation.

Figure 3: **Chinese development will lead to the creation of a large 'middle class'**



Source: McKinsey, World Bank, Willis Towers Watson

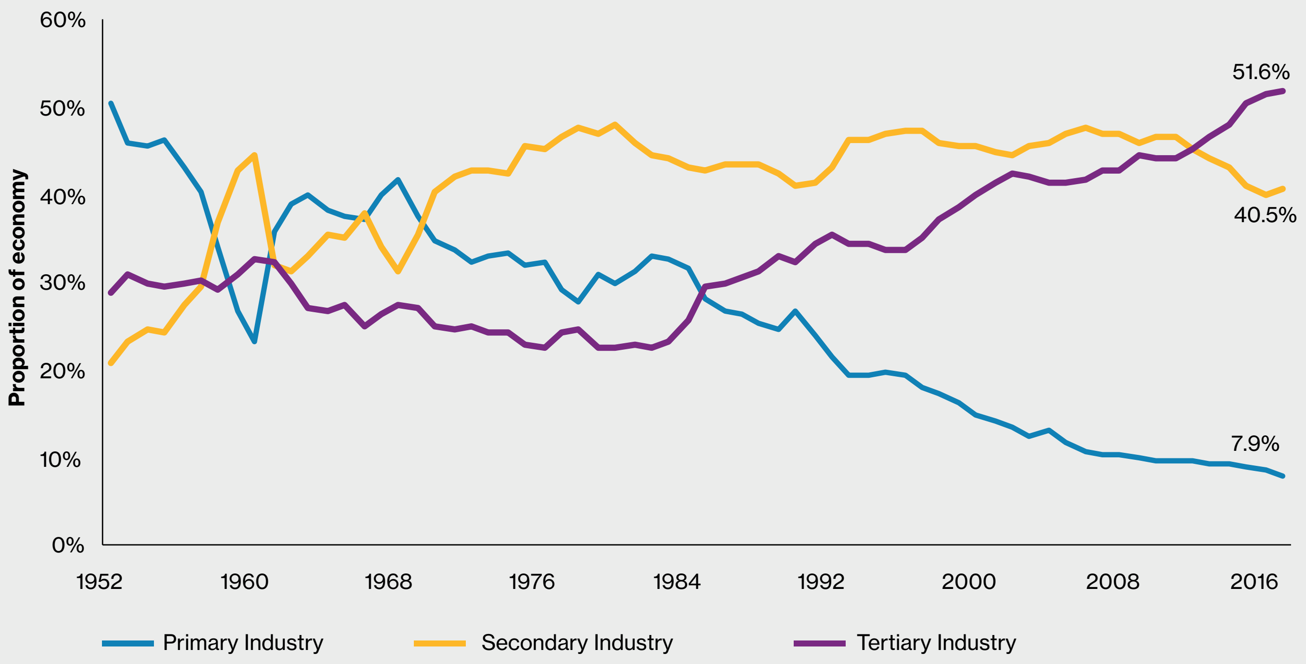
Box 1: An overview of the Chinese economy

On a Purchasing Power Parity basis the Chinese economy is either the largest or second largest in the world (methodologies vary), whilst on market based exchange rates it still trails US and Eurozone. Whatever the method of measuring China's economic might, it is huge. This can be seen in its voracious consumption of commodities, share of global fixed asset investment (both ~40% of global markets) or even financial might.

Whilst the Chinese economy remains a heavily centrally planned market, with its own regulations and idiosyncrasies, authorities have increasingly recognised the use and need of private enterprise and finance. In the late-1980's the capitalisation of joint stock banking institutions marked the relaunch of the nation's equity markets and the beginnings of a modern capital system.

Today, China's economy is moving towards a state of 'moderate prosperity'. Whilst economic growth rates have slowed in recent years, emphasis has moved away from GDP targets towards the quality of growth (less investment more consumption) and other strategic goals such as international relations and investment ('Belt and Road'), production upgrades ('Made in China 2025'), the environment, and dealing with prior debt build-ups in the local government/ corporate sector.

Figure 4: **China's development has been marked in recent years with the economy re-orientating to higher value add industry**



Source: NBS China, Willis Towers Watson

Box 2: The size of the opportunity set, Chinese liquid asset markets

Chinese asset markets rival Japanese markets in size and are clearly second to the US only.

Rank	Equity market Cap		Government Bonds Outstanding	
1	**United States**	**$27,469**	United States	$14,180
2	**China**	**$9,294**	Japan	$9,540
3	**Japan**	**$5,444**	China	$5,828
4	**United Kingdom**	**$3,074**	Italy	$2,295
5	**France**	**$2,417**	France	$2,285

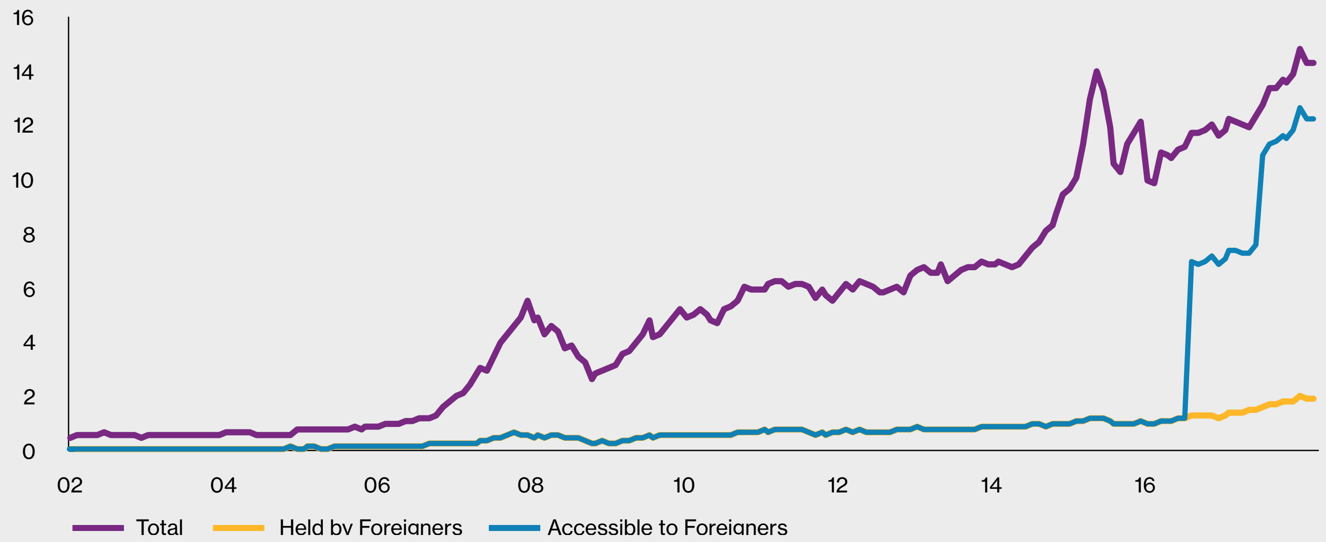
Source: MSCI, Bloomberg LP, Willis Towers Watson

Box 3: The process of Chinese asset market and capital account liberalisation

Since the turn of the millennium Chinese policymakers have been working to open various Chinese markets to foreign investment. The process has followed a deliberate and cautious pattern, with new steps being carefully analysed for impact. For instance, following capital outflows in 2014/15 authorities took steps to restrict the movement of domestic capital. However, liberalisation and financial maturation remains a central policy in China's 13th Five Year Plan.

It is worth noting that these programmes and the trading infrastructure that sit around them remain fairly immature in nature and so we are cautious around execution within onshore Chinese asset markets. However, our research shows that best in class institutional asset management is able to operate in Chinese asset markets. Below, we note some key steps in the opening up of the bond and equity markets for foreign investment.

Figure 5: **Size of onshore markets and their accessibility to foreigners (USD trillion)**



- 2003 – first Qualified Foreign Institutional Investor programme launched – allowing foreign investment into China
- 2006 – first Qualified Domestic Institutional Investor programme launched – allowing outbound investment from China
- 2011 – Renminbi Qualified Foreign Institutional Investor programme
- 2014 – Shanghai-Hong Kong stock connect programme
- 2016 – Shenzen-Hong Kong stock connect programme
- 2017 – Hong Kong-China bond connect
- 2018 – Frameworks and investment limits widened

Source: MSCI, Bloomberg LP, Willis Towers Watson

Further information

For further information, please contact your usual Willis Towers Watson consultant or email:

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What are megatrends?

Megatrends are dynamics that result in multi-dimensional transformations across societies, technology, economies, the environment and politics. From an investment context we consider the impacts of megatrends within an integrated system of economies, corporate industries and global capital markets allowing us to construct portolio influencing insights that improve the risk and return properties of our clients' portfolios.

In our report "Responding to megatrends", co-written with the PRI, we outlined five megatrends (technology, society & demographics, environmental challenges, globalisation & connectivity and emerging market growth & dynamism) that we and the global investment community believe will have material transformational impacts over the short and medium term. For further information please follow the link:

https://www.willistowerswatson.com/en-GB/insights/2017/12/2017-investment-institutions-trend-index

About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 45,000 employees serving more than 140 countries and markets. We design and deliver solutions that manage risk, optimise benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas – the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

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