The PODfolio Podcast Episode 12: China

LIANG YIN: See, I'm not here to predict that China will overtake the US as the global economy. I don't think anyone can. But I am here to say that adding Chinese assets to an US-centric portfolio will make the portfolio much more robust to a wide range of future outcomes.

NARRATOR: Welcome to the PODfolio, Willis Towers Watson investment podcast series, where we'll give you an update on the latest developments across global markets, and talk to expert guests on hot topics that matter to institutional investors and their portfolio.

LOK MA: Hello, and welcome to this episode of the PODfolio podcast. Looking at the case for investing in China, a.k.a. my motherland, so this topic is very close to my heart. I'm your host, Lok Ma, and I'm delighted to have two expert guests joining me today. We have Liang Yin who is a member of our research team on private equity, and he leads our efforts around allocating clients money to China. He's actually based in the UK and he's also been a member of the prestigious Thinking Ahead Institute for over 10 years. So welcome to the show Liang.

LIANG YIN: Thank you for having me today.

LOK MA: And we also have Paul Colwell, who is based in our Hong Kong office. And he leads our portfolio advisory function across the whole of Asia, so welcome to the show Paul.

PAUL COLWELL: Hi, Lok. Pleasure to be here.

LOK MA: Our topic for today: is there a case for institutional investors around the world to allocate more of their assets to China as that market continues to open up? Now if the answer is yes, is now a good time for doing that? And how would you actually go about doing it? All say, just for a little bit of fun I guess, I kind of see it as my personal duty to share some interesting parts of my culture where I can. So I will try to draw on some traditional Chinese Proverbs, just to add a little bit of color to what we're talking about. So let's start, then, with the strategic top down case for investing in China.

And we're going to start with you, Liang, and I'm going to I'm going to give you the first of my Chinese Proverbs and it goes like this. The heavens will bring unpredictable winds. What I mean is, if you follow the news about China, that there is a perception that it's a country that's driven by strong forces, acting in both good and bad directions. Can you just first of all, give us some idea of these kind of opposing forces to set the scene a bit.

LIANG YIN: Of course, Lok. Let me start with some of the negative forces, and then circle back to the positive side. I think it's fair to say that a lot has happened in the last year or so. I think this quote from Lenin particularly resonates with me. There are decades where nothing happens, and there are weeks where decades happen. I think today humanity is fighting against a once in a century global pandemic that has claimed millions of lives already, and with no sign of abating. And China as a country where the outbreak started, so its economy hit pretty hard, broader restrictions and lockdown measures I think has also caused massive disruptions to global supply chains.

Many governments have now learned a painful lesson of relying on global supply chain to produce critical routes, and there is a strong desire to bring some of those on shore. Because of China's prominent role in global supply chains, many believe that these economic and reshoring developments are going to have a negative impact on China. In addition to those economic challenges, I think China's geopolitical standing in the world has clearly also evolved. As example, in July 2020 China's foreign minister, Wang Yi, acknowledged that China's ties with the US are at their lowest point since the normalization of a relationship, I think in 1979.

On the positive side, I think after an aggressive and early shut down, that very effectively brought the pandemic under control, the Chinese economy has now strongly bounced back. China stands out as one of the few economies in the world where economic activities has returned to near 2019 levels. Chinese authorities have also continued to address restrictions and barriers to foreign participation in their capital markets. I think foreign ownership of the Chinese financial markets continues to rise, and the foreign direct investment has also remained very robust. It is fair to say that China's integration into the global financial markets has deepened, despite a negative political rhetoric and economic reshoring talk in the US.

LOK MA: So you were talking about US China relations and that's kind of bringing to mind another proverb, and it goes like this. In a fight between two tigers, at least one will get injured. And I'm obviously talking about this kind of jostling between China and the US to be the dominant force in the world, if you like. And it's something that can have quite a wide ranging impact, I think, including on investment outcomes. So what do you think could happen? Does one tiger have to get hurt, or can they learn to get along in some way?

LIANG YIN: Yeah. Thank you, Lok. I really like how you asked the question. It is really about what could happen, as opposed to what will happen. And to be investing is all about building a portfolio that can cope with a wide range of future possibilities, rather than trying to precisely predict what will happen. I don't think anyone can, really. Add to help with that, we like to build out some future scenarios by thinking about the underlying forces driving the future. I think are two important ones here.

The first one is the geopolitical order, and as here I see three potential of future path. One path is that the world goes back to the post-war, US-led uni polarity. Another path is that China surpasses the US in economy, technology, and the military powers. And the third path is that neither the US nor China is powerful enough to dominate. So they either learn to co-exist, or sort of trend towards Cold War 2.0, with the possibility of other power blocks emerging, as well.

The second force is the process of global economic integration. And here, I also see three different potential path. So we can stay on the path to globalization, where global trade stays close to the current high level, or even gains new momentum. Or we could go down the path, instead, to regionalization. And that is where the world economy kind of ends up resting on three pillars and that is America, Europe, and Asia led by China. And the supply chains are brought back closer to these three regional powers, and there will be barriers to trading across these regions.

Then, at to the more extreme end, we can even go down the path to the end of globalization. Something like a repeat of 1913, where countries adopted a dangerous zero sum mentality, driven by nationalism and a lack of global leadership. So if this happened, I think that would

be very disruptive. We could see a meltdown of global trade, financial markets can stop operating globally, with many nations adopting harsh capital control measures. So we have the force of geopolitics on the one hand. On the other hand, the path for global economic integration. How might these two interact with each other? And that is what we'd explored in our research paper Allocation to China In A New World Order.

In a nutshell we think there are five plausible ways we can combine them. One scenario is continued globalization in the world dominated by the US. Another is, again, continued globalization, but China being the dominant force. Then we have three more scenarios based on a multipolar world not dominated by any one country, with higher or lower levels of economic integration. Out of all of this, the scenario we think is most likely to happen is a multipolar world with no dominant power and a greater regionalization, where the world economy and supply chains separate, somewhat, into different regions.

LOK MA: So, Liang, you've very sensibly I think, considered a number of different scenarios for how things can play out. So no one side or the other can come out on top, so to speak. But more likely, you're saying we move to a multipolar, maybe a little more separated world, with different possible levels of cooperation between the regions. So, weighing all of these different scenarios, what does that tell me about how much you want to invest in China?

LIANG YIN: Yeah obviously investors allocation to China will vary quite significantly in these different scenarios. And also the scenarios themselves are not equally likely. What we did in the paper was to assign a likelihood and an estimate of a sensible allocation to China to each scenario. We don't think either of them uni polarity scenario is likely, and of course, that allocation to China really depends on whether US or China will become the global dominating power. The end to globalization in the multipolar world is also not great for China allocation, because think about it, investing in a foreign nation where everyone adopts harsh capital control measures really doesn't make much sense.

Regionalization in a multipolar world is the most likely scenario for the next 10 years, in our view. Recent events, to me, are really manifestations of the world moving towards that scenario. In the paper we gave it a probability assessment of almost 50%, and we believe China should have a 25% weight in a global diversified gross portfolio, in such a scenario. That weight is even higher than the 19% we give to China in a scenario that globalization regains momentum. Let me repeat this point because it's a very important point.

If you expect that major economies in the world, particularly the US and China to decouple from each other, as many people do, given what has transpired in the last few years, there is an even stronger case for geographic diversification. Why? Because one, you can no longer rely on multinationals to give you the geographic diversified revenue streams. And two, correlation among the asset returns of different countries will decline when their economic cycles are less in sync. It's fair to say that most of today's investment portfolios are very geographically concentrated. For example, MSCI ACWI has a US weight of more than 50%. Its weight to China is around 5%, and that is after three runs of the Chinese A-shares inclusion. To give you a sense of concentration here, ACWI has more exposure to Apple and Microsoft than all Chinese companies combined.

So let me circle back to the scenarios. So considering the likelihood of all five scenario, the conclusion is that investors should consider a China weight of around 20% in their gross portfolios.

LOK MA: Wow, so a 20% allocation to China. I mean that probably means a bigger change in investment portfolios than a lot of the other topics that we've explored, I think, over this series of podcast. So you're talking about making a big shift Liang.

LIANG YIN: Yes indeed, Lok. It is a very big shift. We're talking about trillions of dollars here. But I think it's important to note that it is unrealistic to expect a shift of this sort of magnitude to happen in a short period of time. The opening up and reforms of Chinese capital markets are expected to continue to make great progress over the coming decade. Building exposure to China, I think, iS best viewed as a journey. And that is a journey that you balance the pace of a marked improvements was the imperative to achieve this structural geographic diversity in the global portfolio. I think the most important message is that, the time to start building that knowledge and exposure, is now.

LOK MA: Thanks very much, Liang. So we've talked about the strategic case and now I want to switch over to the more practical aspects of investing in China with you, Paul. And again, I'm going to start with, this is probably my favorite proverb, it's quite long. But it goes like this. The right time is not as important as the right place, and the right place is not as important as the right people. So we're going to go through these things at the time, the place, and the people one by one. So let's kick off with the timing first of all, Paul. Is now really a good time to make a significant shift in your portfolio, with all the uncertainties going on, not just with China, or China US relations, but also more widely with COVID 19, and so on?

PAUL COLWELL: In a word, absolutely yes. Most investors just simply have very little exposure to China in their portfolios. Some will have a tiny bit, if they have a global manager who owns the China mega cap stock. Yeah. Others may have some through an emerging market equity mandate that they might hold into the portfolio, but it's really going to be less than a couple of percentage points at the total portfolio level. And yet we the know the major index providers, they're going to increase the weight to China over the next few years. It's true in both equities and bonds. It's a step change in terms of adding a sizable new market, and it means there's going to be a lot of capital flowing. Liang's just mentioned that.

So in our mind, this should offer early investors good medium term tailwinds that they can benefit from. Ultimately Liang noted, China is much further along in its recovery path post COVID. The shutdowns in Q1, Q2 were severe, they were painful, but they resulted in a lot of pent up demand being accumulated. So now the virus is largely under control, this demand has since been released with a vengeance. It's exploded. We can see a big pickup in consumption. Anecdotally, I saw one luxury brand store, it was in Gunagzhou, and they recently reported $2.7 million in sales in one day after opening up. $2.7 US dollars that's incredible, mind blowing. It tells me the Chinese internal demand and consumption story is very much alive and kicking.

So I'd like to add another point and this is really from a valuation from a market's perspective. I think I would say this that on our assessment the Chinese stock market does seem to offer better value, as well. When compared with other geographies taking a three to five year view. And similar arguments can be made for credit and even government bonds.

LOK MA: So I think on the timing front you're basically saying, the prices are looking good at all say, get in before everybody else does. So I get that point. Moving on to the geography. So, as Liang said, a strong argument for investing in China is that the economy there just behaves differently to Western economies. So you get that benefit from the extra

diversification. Paul in the course of your day to day work, do you see evidence of that difference in practice?

PAUL COLWELL: You do. You see the benefits China is not just a big market. It's also very, very different because the Chinese economic cycle runs at a different frequency to that of the US or Europe. Policymakers are focused on maintaining growth employment, and social stability. And the tools utilized to transmit policy decisions also vary. There's a lot less emphasis on interest rate policy. There's more focus on credit supply through the banking channels, as well as government led fiscal measures.

As an example, the Chinese market has been really resilient in the face of COVID 19, and the subsequent global economic slowdown. Policymakers were really swift to act and provide support to the economy. In the first quarter during the panic, on shore China was down about 10%. That sounds pretty bad, but MSCI World Index was down more than 20%. And we look year to date, think of the performance to the end of September, China is up about 20%. The global market? Basically break even. The point is, not that the Chinese market will do better or will do worse, it's just that because of the structure of the economy, the way the policymakers act, it offers excellent diversification benefits. And that can really help improve the risk return profile of an international portfolio.

LOK MA: Paul, so we've talked about the time and the place. So let's move on to the people. Got another saying for you. They don't all translate very well this one's a bit weird. It goes like this. A wandering dragon will not encroach on a snake's turf. I think it's a statement about the importance of local knowledge. So my point is, how can a how can a Western investor get the confidence that they can choose the right investments without the, kind of, on the ground local knowledge.

PAUL COLWELL: I like that quote as well. There are plenty of snakes in Hong Kong, trust me. I like to go out hiking regularly and you know I've seen King Cobras and plenty of other things slithering on the ground. Look...

LOK MA: Proper snakes, as well.

PAUL COLWELL: Proper snakes, Indiana Jones. Look as long as they don't need to have a presence in Asia to be able to take advantage of this opportunity, but they do need to have well resourced, on the ground partners who they can lean on when making allocation decisions, and when selecting managers. Now we strongly recommended active management. This is absolutely clear. The Chinese market offers rich alpha opportunities. We also prefer specialist, China-focused mandates. Our studies, our research, has shown that the median act of China age share manager has outperformed the benchmark by something between 4% and 7% net of fees over most time horizons. That's an incredible result when you compare it against most other markets.

A key reason behind this is that the Chinese market really is dominated by retail investors. They tend to be short term and they're momentum driven. And they really do pay less attention to the corporate fundamentals. And their presence is exasperates the market volatility and creates wonderful opportunities for managers who can take the long term view, who can focus on the fundamentals, and avoid those companies with governance and business challenges.

LOK MA: And I think, Paul, what you said really resonates with me, because I remember growing up in China kind of listening to adults talk about their own investments and equities was just part of my childhood. It was kind of a part of the thing that people do, investing in your own money in the stock market, in a way that you don't really see out here in the West so much. So the timing is right, the geography offers you an advantage in terms of diversification, and you have the right people to realize that alpha potential that is particularly there, compared to other places. So what kind of size of allocation are you looking at?

PAUL COLWELL: Yeah. Look, for most investors, international investors, the first allocation into China is going to be through their equity portfolio, and that makes sense. It's the first market to open up to international investors, and getting access now is actually pretty straightforward when you think about it. So if we look at that first. And off the equity portfolio our thinking is that between 10% and 12% should probably be allocated to a dedicated China Asia's position. Now you might be wondering, well Liang just mentioned 20%.

LOK MA: Yeah.

PAUL COLWELL: That 20% target, mentioned by Liang, is for the entire growth portfolio in getting private markets and credit and other things. And it is something we will look to work towards gradually, over time, with our clients. So this position that I mentioned, 10% to 12%, should sit next to a developed market and emerging markets portfolio, with the global having about 80%, I'd say. And the remainder sitting in emerging markets. You might also ask and say, well, shouldn't there be some overlap in exposure? Yeah, between China and emerging markets and in the portfolio? And to a degree that that's fair, and there may be, but we believe fundamentally the holdings there in the China portfolio should be quite different to the types of stocks we would normally expect to see in a emerging markets portfolio.

LOK MA: So let's get into the, really kind of, practical aspects, then Paul. And think about how you actually make these investments. So what kind of funds are available and also do you prefer to invest directly in the Chinese stock market say? Or indirectly through some of the other exchanges?

PAUL COLWELL: Well we're not fans of simply allowing your global manager to invest into China. That's something I've heard a lot about in the last few years. To be honest, we also have concerns that most emerging market managers, they're just not well equipped, really, to properly take advantage of this opportunity set. Lok, look you'll be surprised to learn this, but many emerging market shops, they just don't have a sizable presence in China. Even though, even though it's by far the biggest market in the universe. Such portfolios run by emerging market specialists tend to be strategically underweight China for various reasons. There are a number of biases that they may hold, in regards to China, and really that's why we prefer a specialist Chinese mandates. So you can be sure that you're getting that exposure.

Now in the past, the only available route was through a specific vehicle which had attained a quota from the Chinese authorities. And that's one of the key reasons why we haven't seen large investment allocations. There was a limited amount of capacity and there was a small number of players. However since the introduction now of the Hong Kong, Shanghai, Shenzhen stock market connect, it's much easier to access this market. There are many strategies available for investors to choose from. Essentially what you're doing is you're

looking for a manager that can buy stocks listed on the mainland Chinese exchange via their brokers in Hong Kong.

We have categorized managers as being onshore, those based in mainland China, and those offshore, who are typically based in Hong Kong or Singapore. But who have extensive local resources that they can call on. Typically we find that the offshore managers have stronger institutional frameworks when compared against, say, the onshore names. This actually makes sense when you consider that often the manager that we're looking at is the regional office for a larger global asset manager, or they may be a boutique, but has been set up by staff experienced professionals that might have been leading emerging market or Asian equity strategies. They know what it takes to meet institutional standards, in terms of controls and an established process. We do see marked improvements in the quality of the offering in the onshore manager level in recent years,

LOK MA: Paul, I want to give you one last question. And here's my kind of final proverb for you, and it goes like this. Water keeps the boat afloat, but it can also overturn the boat. In other words, we've talked a lot about the positives for investing in China. But let's not forget about the kind of corresponding dangers, as well. So what potential pitfalls can you see, both in terms of picking the wrong managers say, and also any unforeseen problems with the companies that you're investing in?

PAUL COLWELL: Look picking skillful managers who can deliver stable returns over the long run. It's really, really difficult. There is a huge dispersion in performance. The gap between the best and worst can be as much as 15 percentage points per annum. And we've seen this over the last five years in particular. It's also common, we find, that the best performers say in a given three year period, they can actually quite likely end up being in the worst category in the next period. So my advice is don't chase performance when looking choosing your China manager. You really need to do your homework. Really do. Can't emphasize that enough. That's why we spend on average more than 200 hours, painstaking research, and risk assessment on the managers before we can rate them preferred.

We've been researching this market now for over 20 years. Along the way I think we've developed some learnings, and an appreciation of the nuanced issues one needs to consider when selecting managers. As well, importantly, the pitfalls to avoid. Maybe some examples might help, Lok?

LOK MA: Yes. Please, please.

PAUL COLWELL: Yeah. OK. Well look, it's common to see inconsistent investment processes being applied in either stock selection, portfolio management, and risk assessment. The other thing that we see is quite common is really excessive turnover in the portfolio. And I mentioned earlier about the retail investor being quite prevalent, well actually you'll find that many of the institutional investors, they act like retail investors. They're very, very short term in their behavior.

The other thing worth highlighting, I think, is look, when we do our research, we find that so often we see there are very inexperienced managers and stock researchers running money on behalf of institutional investors. But many of these individuals, they just won't have lived during more than one market cycle. And that, in itself, can be a bit scary. And there's often poor capacity management, which means that they're in an asset accumulation phase without

really thinking about the implications of gathering assets too quickly, and how they manage their portfolios. That's something that we think is important.

The final one worth mentioning is that, we do see that's often quite the case where there's weak alignment of interest, and not to mention poor sustainable investment practices, or even weak cultures. That sounds like quite a list of things to be aware of, and it is. We, as you would expect, look we set a high bar. It's calibrated to global institutional quality standards we have clients, international clients, we're looking to make their first investment. We want to give them the confidence that what they're investing in, makes sense, and can deliver. Many of these candidates, that we research, that they just don't make it past the first round of due diligence. They really need to be careful. They're just not institutional grade quality. But even that, taking all that into account, we still have amassed through that period of time. A good stable of preferred managers. Where our clients can invest, where they have, we have, high confidence in their skill and ability to generate good sustainable alpha, durably, overtime.

LOK MA: I mean I would summarize all those very, very good opportunities in a strong case for a much more meaningful allocation to China, but you've got to do it carefully, because there's dangers, as well. So thank you very much for that, Paul. That was truly fascinating stuff. So thank you for coming onto the show.

PAUL COLWELL: Thank you for having me.

LOK MA: I also just want to bring Liang in before we wrap this up. So Liang, any final messages from you?

LIANG YIN: Thank you, Lok, for giving me this opportunity because I actually do have of final message.

LOK MA: Go for it.

LIANG YIN: It is a slightly technical one but I do have a PhD degree, which might explain why have the softer spot for that sort of stuff. The point--

LOK MA: I'd expect nothing less from you, Liang.

LIANG YIN: The thing I want to talk about is about risks of commission, versus risk of omission. So what are they? Risks of commission are risks of doing something. In this context, these are the risks in relation to making an investment allocation to China. You know, everyone talks about risks in this space. It is a very extensively covered area. I think recent events brought a few them to the top of the investors' minds, as we discussed in this podcast.

Now risks of commission or, sorry, risks of omission are risks of doing nothing. Now you see when investors do not make any portfolio changes, they continue to hold their current allocation. The risks of this decision are often overlooked. I think the reality is that most investors hold a legacy portfolio that it is very much built around a US led unipolar world. I think there are reasons to believe that the world order has begun to shift, and this legacy portfolio is not particularly resilient to that shift.

See, I am not here to predict that China will overtake the US as the global economy. I don't think anyone can. But I am here to say that adding Chinese assets to a US-centric portfolio will make the portfolio much more robust to a wide range of future outcomes. So in this sense, risk of omission are far greater than the risk of the commission. And that is the final point I want to make.

LOK MA: Thank you very much. That's a great note to wrap up on, so thank you very much for your time, Liang, as well.

LIANG YIN: Thank you, Lok.

LOK MA: And I hope our audience also enjoyed our discussion on investing in China, so thank you very much for listening.

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