FINANCIAL STANDARD.

Investment *Sponsored by*

China A-shares to shake up EM funds

BY KARREN VERGARA AND DARREN SNYDER | WEDNESDAY, 13 JUN 2018 6:01AM

The recent inclusion of 226 China A-shares to several MSCI indexes is opening a floodgate of foreign capital to the Chinese equity market and at the very least disrupting the $2.6 trillion which tracks the MSCI Emerging Markets Index.

Phased in over a two-stage process and completing in August, HSBC says more than $783 billion of foreign investment is expected to flow in to the A-share market over the next five to 10 years.

HSBC head of China client strategy for equities Jean-Paul Linschoten says the move will see differences in the way investors approach A-shares and learn more about the 1500-odd Chinese companies eligible via Stock Connect.

"In the short term, some investors will give out mandates to more experienced China managers before eventually bringing their assets back in-house as they gain more insight and understanding," he says.

"Some will invest in broad or sector-based products such as ETFs or swaps, while others, as we have seen with Stock Connect, will stick to the 'foreign darlings' where foreign exposure is concentrated around a small handful of stocks."

When the A-shares inclusion was announced a year ago, it immediately triggered interest from foreign investors wanting exposure to internet stock giants such as Baidu and Alibaba.

But as China's emerging market index concentration grows, iShares says investors might be better off adopting a single country focus on China by rethinking emerging markets to exclude China.

"Global ETP flows suggest investors are doing just that: EM equity flows have been increasingly single country focused over the past year - a notable contrast to developed market flows which have favoured broad exposure," iShares says.

Pzena Investment Management portfolio manager Allison Fisch, who co-manages the Pzena Emerging Markets Value Fund, says her recent trip to Australia included several questions from institutional investors about the A-shares inclusion.

Fisch says while the A-shares will now all be included in Pzena's investment universe, "today that market remains more expensive."

As a classic deep-value manager it's only interested in stocks that turn up in the cheapest quintile or 20% of its investment universe.

"The index is very concentrated," she says, "and the top five names in the EM index now account for about 20% of the holdings and that includes these very highly valued internet names, Alibaba, Tencent etc."

"If you just look at Naspers, more than 100% of its value comes from its stake in Tencent, and they account for a third of the return of the index for the last five years."

If you haven't owned those stocks, it's been tough but "it's not a situation that lasts forever and history would tell you that you don't really want to own the biggest names in the index."

SURA Asset Management regional head of equities Felipe Asenjo Wilkins, says Australian investors targeting emerging markets have generally lent towards BRIC (Brazil, Russia, India and China) stocks as well as wider Asia. However, he says the Pacific Alliance trade bloc comprising Mexico, Colombia, Peru and Chile, has created a third emerging markets sub-set with attractive fundamentals.

Wilkins, who also acts as investment manager for the King Irving Sura Pacific Alliance Fund in Australia, says the alliance provides protection against risks relating to China and Asia generally which otherwise dominate emerging market portfolios.