AS CHINA AWAKENS, WHAT IS A CHEAP AND GOOD SOLUTION TO ACCESS A-SHARES?

As China opens up further to foreign equity investors, index investment looks to be a smart way to allocate to A-shares

A good time to buy A-shares?

From last November to this May, Chinese equity markets did well, rising after a five-year period of flat performance and gaining more than 60%. But in June, the offshore A-shares market experienced a sharp correction, mainly due to tightened margin financing regulations. Aiming to restore investor confidence, China took a series of measures in early July to stabilise the market and rebuild investor sentiment. We expect the market worries to fade gradually, enabling the A-shares market to resume the uptrend, albeit at a more sustainable pace.

The eventual inclusion of A-shares in the MSCI global market indices could add momentum when the uptrend resumes. There is no precise timing for the addition of A-shares to these benchmarks, which has become more likely as onshore Chinese equity markets open up to foreign investors, but inclusion appears to be a given now that MSCI in its latest Market Classification Review announced that it expects to incorporate A-shares in the indices after a number of issues have been solved. With the China Securities Regulatory Commission (CSRC) and MSCI forming a working group to tackle those issues, we believe that A-shares inclusion is now just a matter of time. With such a move becoming more imminent, investors worldwide are likely to start working on gaining adequate access to the domestic market. This could be done through the Stock Connect initiatives, the QFII (Qualified Foreign Institutional Investors) and RQFII (Renminbi Qualified Foreign Institutional Investors) schemes or through the products and services offered by investment managers.

Since China represents 12.3% of global GDP, but has a weight of only 1.8% in global mutual funds, we believe there is ample scope for a reweighting as Chinese financial markets open up further. Overall, such a reallocation by global investors could last one to two years, encourage flows from international investors into China and support A-shares.

Smart and cheap solution for beta exposure?

For investors seeking to invest in the Chinese equity market, passive strategies can be a useful way to gain inexpensive and stable beta exposure. Most passive strategies offered in the international market (offshore China) are tracking the various onshore indices. However, due to restrictions for international investors on trading China onshore equities, such ETFs (Exchange Traded Funds) often have a very large premium/discount and large bid/offer spread.

For ETFs tracking the CSI 300 index – the first and most frequently quoted onshore China equity index – the absolute value of the offshore CSI 300 index ETF premium/discount is three to 30 times that of the onshore ETFs. For physical ETFs, the absolute value of the offshore CSI 300 index ETF premium/discount is three to five times that of the onshore ETFs. On average, an investor already loses 0.5% to 1.5% when buying offshore ETFs. The loss due to the premium/discount effect could be as high as 12%-13%.

If you tend to stick to the norm, you could lose more due to the bandwagon effect. Affected by the supply and demand of ETFs, the premium will most likely rise when you buy and a discount is more likely when you sell since many investors are doing exactly the same. This is especially true for the Chinese equity market as the usual creation/redemption mechanism that helps with ETF price adjustment is unavailable due to local regulation constraints.

Index funds as a solution to access onshore shares

Index funds can easily solve the problems of ETFs. With an index fund, there are no price uncertainties; it trades at the net asset value, offering a fair price to the investor, avoiding trading price losses. Index funds can offer a full replication with a low tracking error. We estimate that a 0.5% tracking error is achievable for this market, which is attractive for a portfolio manager as ETFs can have a tracking error of 8.0% to 25.0% due to the large premium/discount effect.

While offering investors flexible and liquid access to A-shares at low fees, an index fund can be expected to help investors capture the benefits of accelerated reforms in support of quality growth, further monetary easing, the eventual inclusion of A-shares in MSCI indices, as well as the low correlation of the CSI 300 index with other global assets.

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