Exposure to China's diverse range of opportunities

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CHINA has come a long way since the 1980s, growing by leaps and bounds to become a global economic powerhouse. Today, it is the second-largest economy in the world, with an approximate 16 per cent share of global GDP. With continuing economic reforms and a shift towards a more sustainable growth model, China is fast catching up with the US, and it is just a matter of time before it topples US to become the number one economy in the world.

Mirroring the remarkable economic growth is its stock market, which has reached a total market capitalisation of US$6.5 trillion in 2018, making China home to the second most valuable stock market in the world. Given its gargantuan economy and stock market, China is simply too big to ignore for investors who wish to construct a globally-diversified portfolio.

Navigating China's different share classes can be a challenge

China's thousands of publicly-listed companies are categorised into various share classes, each with distinct characteristics (see top table). While the majority of them are listed on mainland exchanges, such as the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE), there are also a handful of companies that have chosen to list on other exchanges, like the Hong Kong Stock Exchange (HKEX) and the New York Stock Exchange (NYSE). In total, roughly a fifth of all Chinese equities are listed outside the mainland.

With so many different share classes available, investors often face the tough question of which ones they should invest in. Most investors resort to predicting the next best-performing share class, which sounds like a good idea in theory, but like most things, it is easier said than done.

If we analyse the returns of various share classes over the past 10 years, two important observations stand out. First, none of the share classes were consistent outperformers during this period. Second, there was no discernible pattern that would have allowed investors to successfully predict the next best performer (see graphic).

Coupled with the fact that most China-centric ETFs in the market only provide exposure to a single share class, navigating China's equity market can be a huge challenge, especially for investors who are seeking comprehensive exposure to all classes of Chinese equities.

For example, if you had bought into an A-share ETF, you would not have exposure to HKEX-listed Tencent, one of the largest tech companies in China. Similarly, a H-share ETF will not give you exposure to certain prominent mainland Chinese companies, such as Kweichow Moutai, the world's most valuable liquor company. Even if you own both an A-share ETF and a H-share ETF, you will still lack exposure to China's home grown e-commerce giant Alibaba, which is listed in the US.

In light of this, investors who wish to obtain complete exposure to all Chinese equities will have to own multiple ETFs. The idea of buying multiple ETFs for exposure to a single country may not appeal to some investors, as this adds to transaction costs and the amount of effort required to monitor multiple ETFs.

One strategy to trade them all

Fortunately, there is a solution for all the above-mentioned problems. Investors who wish to capture the entire growth potential of China with only a single instrument can consider using ETFs which adopt a total China approach. These ETFs track indices such as the FTSE Total China Index, which typically comprise over a few hundred holdings across various share classes of Chinese equities (see pie chart).

ETFs like these provide diversified exposure to the entire universe of Chinese equities, sparing investors the stress of accurately predicting the next winning share class and the pain of monitoring multiple ETFs in their portfolios.

The mix of share classes within these ETFs also helps to mitigate the volatility of the retail-dominated A-share market, which has a reputation for being the most volatile market among the lot. Besides diversifying across multiple share classes, these ETFs also offer balanced exposure across various Chinese equity sectors, unlike most A-share and H-share ETFs which can be heavily weighted towards the financial sector. With lower concentration risk, the probability of large losses during periods of heightened volatility is reduced. Given the size of China's economy and the rate at which its stock market is growing, China plays an increasingly important role in global equity markets. MSCI's move to include China A-shares in several of its key indices also underscores the importance of Chinese equities. Currently, Chinese equities constitute roughly 30 per cent of the MSCI Emerging Markets Index. At full inclusion, the proportion of Chinese equities will exceed 40 per cent of the index, making China an essential component of every globally diversified portfolio.

From a portfolio perspective, an allocation to Chinese equities can yield significant diversification benefits, as they have historically exhibited low correlations with other major equity markets. Investors who do not have any exposure to China should consider including it, and one of the easiest ways to do so is through an ETF such as the Vanguard Total China Index ETF or the iShares MSCI China ETF.

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