RISCURA

China as a separate asset class

Active management opportunities

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More information?

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Introduction – Riscura, South Africa and China

RisCura is an emerging markets investment advisory firm who have developed an expertise in researching local managers of China A shares. One of the areas in which they have applied their expertise is South Africa. This is relevant here because it was an initiative to diversify Naspers' 25% weight in the SA index driven by its shareholding in Tencent which motivated RisCura to find a less concentrated way for SA investors to access Chinese equities.

The dominance of local retail investors makes China fertile ground for professional asset management. To its credit Riscura has helped its clients deploy more than $1billion to China in the last 2 years. This includes a $800 million multi-manager fund established in Ireland using a mix of global and local Chinese managers that its smaller SA clients have supported. Other larger clients have invested approximately $1 billion directly with managers that RisCura has researched. The firm's total client base is around $250 billion, most of which is invested in emerging and frontier markets.

China A share market – size and access

The China A-share market was launched with just 6 securities in Shanghai in 2000. Since then it has expanded dramatically and now comprises over 1,500 securities in Shanghai and 2,200 securities in Shenzhen. Its total market capitalisation of US$ 10 trillion exceeds that of the UK and Japanese markets combined and makes it second only to the US in the world ranking. Throughout this 20-year period the A-Share market has largely been closed to foreign investors and Chinese investors have had little capacity to invest offshore due to capital controls. A handful of foreign managers have been able to gain access by obtaining QFII (Qualified Foreign Institutional Investor) licenses but even today foreign participation is just 4% of the total market.

This situation changed significantly when the Chinese launched Stock Connect to facilitate the desire to encourage inward investment. Stock Connect is a trading and clearing facility which allows foreign investors to trade in A-shares though Hong Kong. Similarly, Chinese investors can now access foreign stocks listed in Hong Kong.

It was the advent of Stock Connect which persuaded MSCI and FTSE Russell to bring China A-shares into their global and emerging markets indices as China had for the first time met the test of investibility. During 2019 both index providers applied an inclusion factor which brought the representation of the China A-shares free float up from zero to 20% in MSCI and 25% for FTSE Russell.

Chinese Specialist Managers

The majority of the 96% domestic ownership is held by retail investors. Retail investors are notoriously vulnerable to behavioural biases which lead them to follow rumours and chase stocks without any fundamental information. The remarkable expansion of the Chinese middle class enabled by smart phone technology has generated enormous volumes of unguided activity which professional investors can readily exploit.

There are a significant number of mutual funds that cater to this huge retail client base and typically are focused on momentum etc. There is a much smaller set of investment management firms who are attuned to Western institutional norms. Often the key portfolio manager has been educated in the UK or worked on Wall Street etc. Several US university alumni have been seeded by their alma maters. Even with intimate local knowledge and research it is challenging to

cover almost 4000 stocks and they will often specialise by sector and run very concentrated portfolios – 20 stocks is not unusual. These managers are difficult to access and thorough due diligence requires investment professionals with local language skills.

So China has an enormous liquid market which is currently only being accessed effectively by a small number of investment managers. Not only is the underlying stock market very inefficient – for example, 50 % of the c.4000 stocks have zero analyst coverage - but the market in picking managers is also very inefficient. There are a handful of large, sophisticated endowments and national pension plans who have been engaged for some years and far less than a handful of intermediaries of variable quality making forays in this area. There is no one database that covers all the Chinese manager universe.

Investment management solutions for China

So far as we are aware Riscura is the only organisation carrying out thorough manager research, often in Mandarin, into mainland China A share managers with boots on the ground in China. In the absence of manager data bases and performance universes Riscura has developed strong informal relationships with foreign asset owners to promote our shared interest in manager discovery and monitoring. Meeting managers has continued throughout 2020 from the Hong Kong office this year and Covid makes it unlikely that a competitor will emerge in the near term.

We are monitoring 35-40 managers and it is this established research capability which a number of UK pension funds have shown interest in accessing. The need for an intelligent agent on the ground is increasingly recognised as being an essential part of the process when it is impossible to meet managers face to face.

The high degree of portfolio concentration amongst the quality managers makes it desirable to appoint multiple managers to harvest the alpha at sustainable volatility. RisCura can assist in determining how many managers and their individual profiles would be consistent with any particular fund's structure and objectives.

Added value opportunity

As a proxy for what might be achieved we have enclosed the latest fact sheet for the RisCura fund which was launched in October 2018. The first part of 2020 has been a stern test of the manager structure and diversification in the face of one of the strongest external shocks imaginable. It is gratifying to report that the $800 million fund returned 48.4% outperforming the 36.4% market return by 12.0% in calendar year 2020 and is 8.3 % pa ahead of benchmark since inception with a tracking error of just 3.2%. There is a popular perception that investing in China is risky but the evidence is the reverse.

It is widely recognised that capturing alpha particularly at scale is very challenging. It seems clear that the actions of retail investors in the China A share markets provide a sustainable and exploitable level of efficiency that all return seeking investors should be aware of. RisCura has valuable resources to offer in finding managers who can harvest this alpha.