A Case for Going Active – Investing in China Equity

In May 2018, we released a Market Insight which highlighted the inclusion of onshore China equity (i.e. A-shares in many MSCI emerging market indices beginning June 2018), and the subsequent knock-on effects that may have to equity markets in that region. In that piece we presented a passive option to invest in China A-shares, in order to profit broadly from that development. Passive investing is often an excellent choice– it’s generally cheaper and offers the broadest exposure to the market in question. But passive investing isn’t necessarily for everyone. There are a number of benefits to investing in China equity, including A-shares, which some investors may want to consider when selecting their investment vehicles. In this Fund Insight, we discuss some of the benefits to investing in China through an active fund, particularly in light of the change in MSCI indices this year.

Focusing on Market Opportunities

Specific to the announcement, investors should consider active management to invest in A-shares if they believe that the positive effects from A-shares to be unevenly distributed through the market.

In figure 1 we demonstrate the current sector weights for the onshore equity MSCI China A (i.e. A-shares). The inclusion of A-shares and the resulting inflow of capital is likely to affect different sectors in different ways. The degree to which the additional capital supply is helpful depends very much on the need for capital in that sector, the industry dynamics, (including supply and demand conditions) the degree of international competition, and so forth. A skilled active manager will be able to recognize these differences and weight them according to their opportunity, rather than just investing broadly. Figure 1 also shows the sector breakdown of MSCI China (i.e. offshore) and highlights differences in the sector make-up. Again, an active manager would have an opportunity to exploit these differences as the sector opportunities arise between the onshore and offshore China equity markets as a result of the A-shares inclusion.

Figure 1 – Sector Weights: Onshore vs. Offshore

Source: FactSet as at April 30, 2018.
Better Risk-adjusted Returns

More generally, an investor will prefer active management in China equity if they believe that there are positive returns to investment research done in that market. In figure 2 the growth of $10k over the past decade is shown for the MSCI All China Equity versus the Morningstar Greater China Equity category average. In this category, the average manager has modestly outperformed over very long horizons, but with significantly less volatility.

This effect is seen more clearly in figure 3, which shows the 1-, 3-, and 5-year returns and Sharpe Ratios for the MSCI benchmark and the category average. In each period the average returns for an active manager is better than the benchmark, with better risk-adjusted returns at the same time. Again, the average manager is able to produce these returns with lower levels of volatility in each term.

Muted Downside

Lastly, an investor may want to consider an active manager for their China equity allocation if they are concerned with downside protection. In figure 4, risk and return are presented in a slightly unconventional manner. Along the horizontal axis we show risk as the downside capture of the category members against the MSCI All China Equity index, with the usual return along the vertical axis. While not all managers outperformed in this period, they all had significantly less than 100% downside capture versus the index, ranging from about 58% to about 85%. In down markets active managers in this space appear to be able to control risk and protect capital. As China equity has higher than average volatility – annual volatility can be 2x that of the MSCI world – investors who want to be invested in the growth of China can do so in a risk-managed way by selecting an active manager.

Source: Morningstar, May 31, 2008 – April 30, 2018
**Conclusion**

In June 2018, MSCI begins the first of two phases for China A-shares inclusion in many emerging market indices (the second phase will be on August 1st, 2018.) As a result of that move and the resulting capital inflow, investment opportunities will arise, of which investors are able to take advantage. These can be achieved by using a passive, index-based investment vehicle with broad coverage, or by investing in an active fund with the flexibility to invest only where it is most advantageous. Each has its benefits that investors can consider for their own situation. For an investor who wants to have dynamic exposure to onshore and offshore China equity markets, the flexibility of a portfolio manager to invest in the sectors which are most advantageous, and the downside protection of risk management, an active fund is likely best.

In November 2017, Mackenzie Investments launched the Mackenzie All China Equity Fund, which is an active China equity fund with the flexibility and expertise to invest in both onshore A-shares and offshore equities of Chinese companies. Managed by China Asset Management Co., Mackenzie’s China equity asset management partner, the fund takes advantage of the expertise in China's largest asset manager, with extensive experience investing in those markets. We believe that Mackenzie All China Equity Fund is a very strong choice for an investor interested in putting money into this region.

Please speak to your Mackenzie representative to learn more about Mackenzie All China Equity Fund, or for investing in China more generally.