Misconceptions, opportunities and strategic rethinking

In June, Tell Media Group, in cooperation with **East Capital** and **Eastspring Investments**, organised a roundtable discussion at Operaterrassen in Stockholm with Swedish investors, focusing on Chinese equities. Tell Media Group founder Niklas Tell and Nordic Fund Selection Journal editor Caroline Liinanki moderated the discussion.

By: **Niklas Tell** Photo: **Christer Salling**

The discussion started out with Caroline Liinanki asking how to approach China as an investor and what role China should play in an equity portfolio.

MARCUS SVEDBERG: "I think the answer to that question has changed compared to a couple of years ago. A lot of things are happening in China and around the world that merits a re-evaluation of our exposure to China, such as geopolitics and economics. I haven't seen many public statements from Swedish institutional investors about reallocations when it comes to China but I think a lot of asset owners are currently thinking about these issues. My sense is that for many years investors were on a quest to increase the exposure to China and it was more a question about how best to get exposure. This was also part of the globalisation discussion and when globalisation was increasing China was a very big part of that. Now there's talk of deglobalisation, even if I haven't seen it in my research, and that also points to the need for a re-evaluation. I'm not saying that we should reduce the exposure to China but we need to re-evaluate. The result of that re-evaluation can, of course, be to keep the current exposure."

CECILIA SVED: "I think those are valid points. But we should also keep in mind that a lot of investors are very benchmark aware and from a benchmark risk perspective, it's very expensive to exclude China."

PONTUS VON ESSEN: "I think it was back in 2017 when I for the first time heard the animosity between US and China from US investors at a conference. China was then starting to be seen as a competitor and at the time, we still thought that Europe could decouple from that. But after Covid and with the recent changes in the security discussion in the world, it's clear that's not the case. The US and China are going in different directions in many aspects and as a European allocator, you have to think about what that means and the security changes in Europe have only increased that need. We've seen what's happened with the war between Russia and Ukraine and we need to keep that development in mind as we think about China and Taiwan. We haven't changed our allocation to China but if we before Covid were thinking about increasing the allocation, that's no longer the case.

NIKLAS TELL: IS THIS A SIMILAR THINKING TO WHAT YOU HEAR FROM INVESTORS ELSEWHERE?

KEN WONG: "I've been on the road now for a while and many investors highlight the same uncertainties, not least with regards to the regulatory crackdowns we've seen over the last couple of years around technology. But that's also how China operates. Also, if you look long term and then I mean 10 to 15 years, China is something you can't ignore as an investor. Cecilia mentioned benchmarks and it's a fact that China will only become a bigger part of global indices with more listings and bigger free floats. The question is what to do in the short term. A lot of investors have been disappointed with regards to their China exposure in the last couple of years but there are opportunities, especially in A-shares where international investors are underrepresented at the moment. I also think it's important that investors are now again able to travel to China and be able to see with their own eyes what's going on."

CAROLINE LIINANKI: WHAT ARE SOME OF THE KEY MISCONCEPTIONS WHEN IT COMES TO CHINA AND THE CHINESE STOCK MARKET? DO INVESTORS KNOW CHINA AS WELL AS THEY SHOULD?

FRÉDÉRIC CHO: "The short answer is no. I'm, of course, a veteran and saw the birth of the Shanghai stock exchange while being a representative for Handelsbanken, so I've been working in and with China for some 30 years now. It has matured since then but what has stayed with me since the start is the importance of granular stock picking and really understanding individual companies. One misconception relates to the Chinese currency and the fact that it's not fully convertible, which of course is why we have A-shares and H-shares. We must also be aware of the fact that China is a political economy. It's partly market economy and partly state economy and it very much depends on the sector you're looking at. In general, we all need to learn more."

HAO ZHANG: "I agree with Frédéric – we need to learn more. China is a different market in terms of how things work and the government is very involved when it sees something that it doesn't think is good enough. The crack down on education companies is just one recent example. It's therefore important for us as investors to really try to understand what the government is focusing on and how it's trying to shape the economy. That will provide headwinds and tailwinds. We've also seen the importance of local insight where one example is the volatile development of the Hang Seng index, which rallied a lot from October last year until earlier this year when it crashed. The local market didn't have the same movements and the reason for the difference was that international investors were very optimistic on the reopening of China whereas local investors were more conservative and expected a slower recovery."

MARCUS SVEDBERG: "Ideally, these are the conversations I want to have on all markets – gaining real insight on the developments in the economy and society. However, that's not where we are when it comes to China. Now, it's not primarily about how we want to gain the exposure but if we want to have the exposure at all and it has less to do with performance. It's not a tactical decision but rather a strategic decision. Over the last couple of months, I've been at a couple of global strategy sessions and different strategists have said that they are bullish on China tactically but then the first question they get relates to geopolitics. You normally don't trade geopolitics tactically – it's a strategic decision. Also, all of this is made more difficult by the fact that we haven't been able to travel to China for three years."

CECILIA SVED: "Hao, you mentioned the need for understanding the intentions of the Chinese government. That's

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something I never did when investing in the US or in Germany. As investors, we're used to thinking about the government and the stock market as two separate things. In what way would you say China is different?

HAO ZHANG: "The fundamental difference is how society works. In China, the government is seen as the entity that's leading the people towards a better future. In other countries, I think the government is seen more as a facilitator whereas in China it's seen as a leader. The Chinese people expect the government to take care of them."

KEN WONG: "When you invest in China right now, it's difficult to invest in the whole market so taking a passive exposure would be challenging in my view. But there are sectors and companies with clear policy tailwinds, such as EVs and AI. We also see a lot of interesting development in renewables because even if China is still burning a lot of coal, there are targets on what they're trying to achieve to become carbon neutral over the next 30-40 years. Then, from a geopolitical perspective, there are of course still questions that needs to be answered and that's why we see most emerging market equity investors currently underweight China."

PONTUS VON ESSEN: "It's not the short-term trade that's the problem. The challenge is what we do as long-term investors. What will the situation be in 10 years time? Will China be investable then? We are slow moving – we're not a hedge fund. Everything we do needs to be on a five or 10 year timeframe and can we take that view confidently when it comes to China? I think that's the challenge right now."

CAROLINE LIINANKI: SO HOW DO YOU APPROACH CHINA IN AN UNCERTAIN TIME LIKE THIS?

PONTUS VON ESSEN: "It's absolutely too big to ignore and it's not uninvestable right now."

MARCUS SVEDBERG: "The easiest thing to do is of course to do nothing. But we need to make that strategic decision first. Then we can start to think about what we want to think about – if we should increase or decrease the allocation, how we want to take our exposure and things like that. Of course, a strategic decision can be to say we're happy with the exposure we have right now. But to the comment that China is too big to ignore. If you do the math and if we assume a 60/40 portfolio, then you will have some 2 to 3 per cent in Chinese equities. Is that too big to ignore? It's, of course, an important market but from a total asset allocation perspective, it's not that big. It would be difficult but not impossible. And again – it's up for review for structural reasons and not for tactical reasons."

KEN WONG: "Over time, if MSCI includes A-shares at a higher rate by raising the inclusion factor, then China as a portion of emerging markets will of course become significantly bigger and as a result, more flows would also go into the A-share market."

MARCUS SVEDBERG: "Yes, and that used to be important. However, today if you are to make a strategic decision, whatever MSCI does is secondary."

CECILIA SVED: "If you would go to the investment committee, what reasons would you give to exclude some 3 per cent of the benchmark? I don't think it's enough to say that the geopolitical risk is high."

MARCUS SVEDBERG: "This, of course, is hypothetical before the analysis is done. But first one would need to be very convinced and then one would need to

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> – Marcus Svedberg, Folksam

come to terms with what the main reason for taking the decision is and depending on the reason, there would be a lot of different responses. It could be changing from public to private assets in China. If one is worried about the supply chain, then you probably need to think about other markets as well and not only about China. So first we need to do our homework and then take the strategic decision."

FRÉDÉRIC CHO: "I think it will still be important to follow and understand what China and Chinese companies do because they are becoming leaders in many sectors. So even if you invest or not, you risk losing out if you're not on top of these developments."

CAROLINE LIINANKI: WHAT ARE SOME OF THE MAIN BENEFITS IN HAVING EXPOSURE TO CHINESE EQUITIES?

KEN WONG: "We obviously know that China is currently the second biggest economy in the world but I think the big opportunity is that China offers great diversified opportunities for investors. We've already talked about the EV industry and the reason for why that has been successful is that the input costs are much lower in China. Real estate, finance and some of the key industrial related sectors were the key driver for China's economic growth over the last 10 years but economic growth in China will come from new industries like EV, renewables, technology and consumption over the next decade. However, because investors haven't been able to travel to China, they haven't been able to gauge the magnitude of growth prospects that these sectors can offer going forward. As more investors start to visit China again, they will see on the ground how things have evolved. There are misunderstandings."

FRÉDÉRIC CHO: "I agree. There are a lot of misconceptions and one is that Xi Jinping is looking to take China back to how it was in the 1950s. Yes, he has gone after big tech companies but I would rather focus on the project of fostering small giants. That's the 8000 to 9000 privately owned companies that they want to make into stars in each sub-sector that's important to China. That will be interesting to follow and a general recommendation is to look more at what China does than what they say."

MARCUS SVEDBERG: "I think all of that is true and there are a lot of things happening in China, especially related to the green economy. China is globally important in the energy transition for a lot of reasons and A-shares have a low correlation to other global markets. The list is long of what you would be missing if you were to exclude China. That's why it's not an easy decision."

PONTUS VON ESSEN: "It's an interesting topic. China used to be more important from a GDP point of view than from an

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investment point of view. A lot of the profits used to go to US and European companies and it's therefore interesting to see the rise of local brands that Chinese people would like to buy. That will probably continue and then the diversification aspect will only become more important going forward. No one wants to exclude China and just a couple of years ago, we all were looking at how to grow our allocation to China. That's where the growth is and that's where a lot of interesting developments will happen. But then you have these medium-term challenges of trust and where Xi is taking China. The question is also if the US will make it impossible to invest in China."

NIKLAS TELL: WHAT IMPACT DOES CHINA AND CHINESE COMPANIES HAVE ON THE REST OF THE WORLD?

KEN WONG: "Everyone is talking about decoupling and how the US can decouple from China. I think that will be very difficult. It will hit the growth and profitability of US companies and I don't think US corporate CEOs focusing on decoupling from China and other Asian markets will remain very long when it hits their bottom line. Also, we see that businesses in the US operate in one way with regards to China and politicians operate in another way."

HAO ZHANG: "When it comes to decoupling, we do see companies in, for example, manufacturing moving out of China to countries such as Bangladesh. But what has happened is that it's the Chinese entrepreneurs that have moved their operations and now continue to supply their global customers. That's not decoupling. I also think it's worth highlighting that it's not easy to get the same economics elsewhere. We see that Apple is trying to get an assembly line in India but that's not the difficult part. It's getting the supply chain in place locally and this is what makes it cheaper to produce in China. It's not because of low wages – it's the fact that everything around it is cheap."

FRÉDÉRIC CHO: "A good thing is that there's now a consensus in the G7 to talk about derisking rather than decoupling. But then you of course can still have different interpretations of what derisking is in US and in Europe. If the US thinks it can decouple from China, I think it will be the other way around – that the US will decouple itself from the rest of the world economy."

MARCUS SVEDBERG: "I agree and I think it's important to distinguish between the real economy and financial markets. China is the second economy in the world and I think the concept of decoupling in that sense is simply flawed. But as a financial actor, we can certainly derisk and that's something we do all the time. We can derisk when it comes to our exposure to a country, an asset class or a sector. I also think it's important not to think about this in terms of black and white. In some areas there will be conflict and in others competition and in some areas there will be cooperation."

NIKLAS TELL: WHAT ARE SOME OF THE PROS AND CONS OF INVESTING IN CHINA VERSUS INVESTING IN NON-CHINESE COMPANIES THAT BENEFIT FROM SALES IN CHINA?

PONTUS VON ESSEN: "As a universal investor, our starting point is that we invest globally and we're fairly passive from an asset allocation point of view. We don't start by asking how to best get exposure to the Chinese consumer. We start by investing in the MSCI World and then we ask ourselves if there are any problematic exposures we would get that we need to exclude or if there are areas we would like to overweight."

KEN WONG: "In the early years of the Chinese stock market, you had a lot of SOEs (state owned enterprises) and even today you get a lot of exposure to these types of companies if you buy an ETF on the Chinese market. That then influences the way a lot of investors view China but to me, the Chinese stock market is so much more today with a lot more stock diversifications across various sectors."

CECILIA SVED: "When China started to open up and initially became part of the benchmark, we had investment banks coming to us and saying that we didn't need to invest directly into China and that they would create a portfolio for us of international companies with high exposure to China. That was some 15 years ago and I think markets have changed since then. The Chinese market is different today and you will get a different exposure."

CAROLINE LIINANKI: DIVERSIFICATION USED TO BE THE MAIN ARGUMENT THAT I HEARD FROM INVESTOR FOR INVESTING IN A-SHARES. IS THAT ARGUMENT STILL VALID?

HAO ZHANG: "I still think the diversification argument, especially for A-shares, is still valid. Both because you will have different exposures and also because the international ownership of A-shares is still very low."

KEN WONG: "I think if you just look at the numbers, diversification still exist when it comes to A-shares. There's less correlation with international markets. However, performance has not been great recently, so maybe that's the real reason for why investors are reducing their exposure rather than the lack of diversification."

NIKLAS TELL: WHAT ARE SOME OF THE MAIN ESG CHALLENGES WHEN INVESTING IN CHINA?

KEN WONG: "I think it's important to understand that the way the western world sees ESG and the way China sees ESG could be different. One example is Xinjiang, which for China is seen as a great source for solar panel materials and part of its focus on renewables whereas the west will see the ethnic issues and will see it as a huge ESG problem. In general, I would say that China is focusing a lot on the 'E' part of ESG and is really pushing the renewables sector. The big problem is the governance and here you really need to be on the ground and engage with companies to fully understand what's going on and how they are progressing. There is still a lot to be done when it comes to ESG in China but things are happening. We have, for example, seen that stock market regulators in China now tell companies that they must disclose in their annual reports if they've received any fines from regulators in order to provide more transparency for investors."

MARCUS SVEDBERG: "I've spent a lot of time looking at this and there are, of course, a lot of ESG risks in China. But

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I think it's manageable and I think a lot of active managers are good at managing these risks. What we've been looking at is also ESG at the sovereign level. There are surveys on this but many are poor because they will have a strong income bias – so the poorer you are, the worse the ESG score. There are alternatives where you control for level of income and then you see positive and negative outliers when it comes to ESG and China is a negative outlier, especially when it comes to the 'G'. The US is also a negative outlier, as is Turkey. Then there are, of course, great companies in all of these markets but it's a challenge when the sovereign is a negative outlier from an ESG point of view."

NIKLAS TELL: WOULD THAT THEN BE AN ARGUMENT FOR NOT BUYING GOVERNMENT BONDS BUT INSTEAD INVESTING IN CORPORATE BONDS AND EQUITIES?

MARCUS SVEDBERG: "I think it's more complex but yes, that could be one way forward. Specifically for China, it could also mean that you think twice about SOEs if the sovereign is a negative outlier."

HAO ZHANG: "If you look top down, I think a lot is happening and we now see regulators initiating different steps when it comes to ESG. One example is that companies as of 2018 need to have an ESG section in their annual report. Also, the awareness among companies has improved a lot. It used to be that no one really cared about ESG and now a lot of companies are coming to us asking if we can help them improve when it comes to ESG. It's not yet at a similar level as a country like Sweden but I think we need to give the companies time to improve."

CAROLINE LIINANKI: HOW DO YOU MANAGE POLITICAL RISKS IN CHINA? IS IT ENOUGH TO STAY CLEAR OF STATE-OWNED COMPANIES OR DO YOU NEED TO DO MORE?

KEN WONG: "As a fund manager, you need to look both top down and bottom up. You can be the best stockpicker in the world but that doesn't matter if the government comes in with specific regulation that affects a company you've invested in. Understanding government policies is really important when allocating to specific sectors because the policies will either work as a tailwind or a headwind for companies."