Smart Beta and the China Market

China Post Global hosted a conference call with its President Shaun Cai on 22 May 2019. The interview focused on the Chinese A share market and smart beta, and was carried out by Tim Harvey, CEO of NTree, on behalf of China Post Global.

Tim Harvey: Good morning everybody and thank you very much for dialling into today's conference call. Today NTree International is very pleased to have Shaun Cai – Director of International Business at China Post Fund in Beijing – joining us to talk about China and accessing China using smart beta.

The Chinese market is probably the fastest expanding capital market in the world. The rest of the world is obviously being caught up in China's trade disputes with the USA. But with MSCI, FTSE, Bloomberg index inclusion all either occurring last year or this year, I'm guessing China is now too big to ignore. But accessing the China equity markets can still be problematic for European investors when we think about things like timing issues and index construction concerns. So, I'm guessing this is why CPG decided to go with China's first international smart beta ETF as your first China UCITS Fund?

Shaun Cai: Yes indeed. There are two key reasons why we asked STOXX to develop and launch this index. Firstly, there was no suitable China minimum variance index that was available. We wanted a well-diversified, unconstrained index using a modern approach to minimum variance.

Another reason is that we firmly believe that minimum variance is the right systematic strategy for China's A share market, especially at this stage of its evolution. And particularly for European investors, who want to capitalise on China's ongoing growth but often have concerns about market risk, potential losses, shadow banking and excess leverage. The minimum variance strategy addresses all of these concerns, in a systematic methodology. Both by controlling risk at portfolio level, and by reducing exposure to the most volatile sectors – particularly financials.

I'll talk a bit more about financials. Excessive financial exposure in most market cap-weighted China indices is another common concern among European investors. For example, the CSI 300 is roughly 40% financial stocks, and the FTSE China A 50 is roughly 55% in financials. By contrast, the STOXX China Minimum Variance Index is only about 20% in financial stocks – still substantial exposure to a very important sector, but not unbalanced or excessive like many other China indices.

Tim Harvey: There are many potential index partners for China exposure – FTSE Russell, MSCI, CSI. Why did you pick STOXX as an index partner?

Shaun Cai: We chose STOXX over other index providers mainly because STOXX use a superior minimum variance methodology in our view. There are two important ways in which the STOXX approach to minimum variance is superior in our evaluation:

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Firstly, STOXX offer an unconstrained "pure" minimum variance exposure. Other leading index providers typically offer constrained version. They limit the amount by which their minimum variance index composition can differ from that of their market cap index. This effectively means their minimum variance indices only provide a tilt towards minimum variance, rather than a pure minimum variance portfolio.

Secondly, STOXX use a more modern minimum variance methodology than most other leading index providers. STOXX uses a forward-looking factor model, which utilises the full universe of China A shares, and avoids the risk of spurious correlations. Most other leading index providers use a historical covariance approach, which often limits the stock universe to enable computation, and incurs spurious correlation risk. Other min var indices also update their variance data monthly, rather than daily in the STOXX index. The STOXX approach uses a fundamental model to predict and manage risk within the index methodology. It therefore makes more efficient use of investors' risk budget.

Tim Harvey: This is the first smart beta China equity ETF available in Europe (and I think it is the first smart beta ETF available outside the China market). Are you surprised that none of your competitors have tried to issue a smart beta product?

Shaun Cai: Selecting the right smart beta strategy for the China A share market for the next

five to 10 years takes considerable local knowledge and insight. It is therefore not surprising

that the only smart beta China ETF so far in Europe has been launched by a Chinese manager, which has sufficient local knowledge as well as experience with smart beta ETFs. Other managers may follow eventually but it is worth remembering that the market in Europe for China ETFs is relatively young and still evolving.

Tim Harvey: That's very true. Some of the early money is already allocated into MSCI or CSI indices. How do you convince an investor who's already invested in a China ETF to rotate their allocation to your product?

Shaun Cai: That's a great question Tim. China has had a great start in 2019 and Q1 has delivered fantastic performance. But where do we go from here? Market volatility could hit us at any time based on the US-China trade talks like what we have seen in the past weeks. There are other long term initiatives like BRI - Belt & Road Initiative - continue to expand and attract more countries.

But we also have to remember China is not an island and is part of the global economy. So whereas China is experiencing good growth, China is still exposed to the uncertainties of the global economy. So maybe you have had a great run investing in another Chinese A share index and it's too soon to reduce your China exposure, or you want to protect your gains – or minimise your possible draw down, or maybe you've been previously invested in a China index which has too much weighting to H Shares or US ADRs and you now feel you need a pure China A Share play, or maybe you're looking at China for the first time and you are concerned about where Chinese capital markets are in their performance cycle.

Whatever your reason or concern, the STOXX China A Minimum Variance Index which our Market Access ETF tracks, gives investors exposure to the onshore Chinese equity market, the A Share market, while offering investors, be they institutional or private wealth, good drawdown – downside – protection.

But what does drawdown or downside protection mean? It means whenever a market volatility event occurs, the index is already invested in stocks which, systematically, offer the index or ETF investor the greatest protection from market volatility. The most important point to remember is the greater downside protection, the more money you have invested in the market for the next upturn.

And perhaps that's why investors should consider switching; because China is a very exciting market, but still an emerging market. Investing in China can be volatile, with more risk than many European investors are comfortable with. Using the STOXX Min Var index offers investors well-diversified China exposure while still giving strong downside protection.

Tim Harvey: What's the difference between a Low Volatility index and a Minimum Variance index?

Shaun Cai: A low volatility index is one which seeks simply to minimise the portfolio risk without taking into consideration the return profile. A minimum variance index is one which seeks to optimise risk versus return, in order to construct an efficient portfolio according to modern portfolio theory.

Tim Harvey: What are your future plans for ETF issuance in Europe?

Shaun Cai: We will continue to look to add value to investors by filling gaps in the European ETF market which are not well yet well provided for. We will remain focused on our chosen niches of Asia, commodities and smart beta strategies. Equally importantly, we will look to continue being innovative in solving problems for investors.

Tim Harvey: What's the short- and medium-term outlook for the Chinese equity market – where does it go from here in your opinion, and what sectors are you most bullish/bearish on?

Shaun Cai: There are several headlines. For example: The People's Bank of China (PBoC) has conveyed the message of stopping expanding easing, and the market has already priced in this signal. Liquidity will remain ample but contained. The economic slowdown continues although Q1 2019 data offers some comfort.

Three forces dominated China's equity market last year: US-China trade headlines, slowing growth, and tightening policies. With US and China closer to a trade deal in Q1 2019, the market corrected the overly-pessimistic outlook in the beginning of the year. Growth continues to slow down, less than the market expected, yet the trend is still without doubt.

Both monetary and fiscal policy has turned to accommodative since Q2 2018, yet in our view monetary policy has stalled and further easing is temporarily off the table. Fiscal policy accelerated from Q4 2018 onwards and leaves Q4 2019 more uncertain.

We expect the Chinese equity market to be volatile in the coming months, as the market focuses closely on signals regarding trade talks, growth and policy. Seasonally April and May are bad months for Chinese A shares anyway. If the market falls in Q2 and the outlook for Q4 onwards becomes clearer, we expect a rebound in the second half of this year.

Sector wise, we still favour financials and consumer staples. Financial stocks benefit from a market recovery most directly, and their valuation is quite attractive, especially banks. Consumer staples with ample cash flow are always my top picks in a volatile market, though they may underperform in a bull market.

Tim Harvey: What's your expectation for the US-China trade conflict – what developments and timeframe do you expect?

Shaun Cai: There have been some dramatic changes in the past couple of weeks. We still think that a full-blown trade war is a low probability. However, imposed tariffs may have caused an adverse effect on China's growth. Mainly through reduced fixed asset investment. Also, it is rumoured in China nowadays that the US is targeting China's industry and technology upgrades, and demanding the Chinese government removes all subsidies. We believe this is impossible to be accepted by China.

The market is expecting some positive developments by early June before the meeting of presidents at G20 Osaka Summit. More realistically, the final trade deal will probably take a bit longer. Maybe the November APAC is a good target. Of course, in our view, conflict between the US and China will be long lasting, and can't beresolved within such a short period. Yet the most intense standoff has probably ended.

Tim Harvey: A question from Just ETF in Germany. The continued expansion of Stock Connect - what are the implications for RQFII?

Shaun Cai: In our view, Stock Connect and RQFII/QFII are cross border investment programs that are complementary to each other.

Firstly, they are serving different purposes. Stock Connect is more of a trade link that provides swift & easy access to the Chinese A share market via HKEX. "Ease of trading" is the key phrase here, which is also a big initiative to "welcome" the MSCI A share inclusion.

The RQFII and QFII programs are mainly targeting longer term foreign investment into China's capital markets, which include the equity market, bond market, derivatives market and fund market. "Investment in China" is the key purpose.

Secondly, both programs are being improved according to market feedback and further opening of the Chinese capital markets. For example, the universe of eligible stocks is likely to expand on Stock Connect. There has been discussion of potential ETF and IPO inclusion. But they are still going to be limited to exchange traded products because of the trade link. The Bond Connect program has been rolled out for foreign investors to trade in the Chinese interbank market. A consultation paper was published on the CSRC website in January this year to further reform the RQFII/QFII program; for example to remove the repatriation limit, to lower the application hurdle, and to include onshore traded derivatives and investment in private funds.

Generally speaking, we anticipate these types of cross border investment programs will coexist and expand for the foreseeable future. We think there will be more trade links being created, and fewer restrictions for foreign investors.

Tim Harvey: A question from WH Ireland in London. Can the domestic Chinese economy absorb any overcapacity created by US trade tariffs?

Shaun Cai: First about trade tension: we don't think there will be a complete shutdown of US-China trade, only a certain degree of decrease, and the cost is borne by both US consumers and China producers. The most significant impact on China is fixed asset investment and secondarily employment. Fixed asset investment has adjusted partially, and employment is much more complicated, but the structural change in China will have less new labour every year and is expected to see a shrinking labour force within 10 years.

Looking in more detail: in 2018 China exported roughly US $480 billion of goods to the US, half of which was computers, TVs and other electronics. The US made 30% of the total exports of China in these categories, and 20% of total Chinese exports. The impact on China will not be impossible to bear. Also, the trade tension began a year ago, most affected sectors have already adjusted partially, as fixed asset investment growth in these subsectors has already been running at historically low levels [see charts provided]. These sectors provide around 13 million jobs in China, down from 14 million in 2013.

So, to summarise, 1) the trade tension won't eliminate US-China trade entirely, 2) the US is a main destination for Chinese exports, but makes up about 30% of most impacted sectors, 3) the key sectors have started to adjust in regard to fixed asset investment, and 4) structural change will also lift some pressure in the long term.

The overcapacity issue is focused in industries like metals, coal, steel and chemicals; almost all real estate and construction related industries. It is a less serious problem as of today, although the time needed to resolve this overcapacity may be lengthened by the trade tension.

Tim Harvey: Do we see stability in USD/RMB?

Shaun Cai: The currency has been much more volatile in the past couple of years than before. Especially recently with the trade tensions the RMB has been weakened to 6.9 vs USD. We anticipate more volatility but there won't be a massive depreciation to counter the US tariffs.

Tim Harvey: Shaun thank you very much for your time today. We really do appreciate your insights. Anybody who is looking for more information on China Post Global's China A Minimum Variance ETF can go to the CPG European website – www.marketaccessetf.com or they can come to us at NTree – www.ntree.co.uk. If anybody has any further questions or comments please reach out to Danny Dolan at China Post Global in London. We will circulate a transcript and a recording of the call. Thank you very much to everybody for your time today. We look forward to speaking to you again in the near future.

Shaun Cai: Thank you Tim.

About China Post Global

China Post Global is the international asset management arm of China Post Fund, a large asset manager in mainland China established in 2006. With offices in Hong Kong and London, China Post Global is a SFC and FCA licensed investment manager with unique insight into the capital markets of mainland China, providing portfolio management and asset allocation solutions for investors worldwide.
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