Investment Insights
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CAPITAL GROUP®

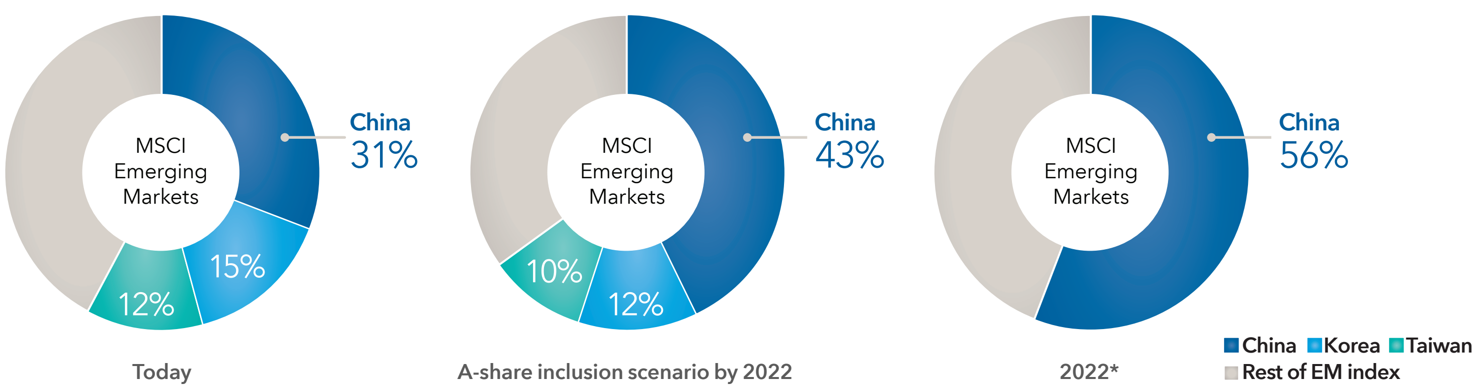
GLOBAL EQUITY INVESTING

China A shares: Doors open to vast stock picker's market

Key takeaways

- China's stock market is being rapidly integrated into global financial markets and presents investors with both significant opportunities and challenges.
- The domestic Chinese A-share universe continues to expand and includes more technology and consumer-oriented firms.
- Stock selection is key, since the quality of companies varies significantly. Market volatility is also high as retail investors dominate trading volume.
- Foreign capital inflows will boost liquidity and change market trading dynamics. Governance standards should improve with more institutional investors in the A-share market.

Get ready: China is set to dominate the benchmark emerging markets index



Sources: Capital Group, MSCI, RIMES. As of 9/30/18. Assumes large- and mid-cap A shares are fully included in the index.

*Scenarios for 2022 are hypothetical. Assumes MSCI moves Taiwan and Korea from its emerging markets indices to developed-market indices.

Chinese stocks are a growing component of global financial markets

China's economy has grown rapidly to become the world's second-largest after the U.S, as has its stock market.

The country's stock market capitalization is a whopping $8 trillion in U.S. dollar terms. But a large part of that is not included in global indices. That's changing, and China could well be on its way to becoming a market that investors may not be able to ignore anymore.

Chinese equities already dominate emerging markets indices. MSCI, which compiles the most well-known international and global indices, bolstered China's presence by adding more than 230 stocks issued by mainland China companies, known as A shares, to its benchmark emerging markets index in June and August of this year.

MSCI and other index providers are likely to continue expanding representation of China's market in these broader indexes. While this evolution is in the early innings, investors will have to calibrate their approach to China's equity market given the country's influential role in the global economy and its march toward becoming a developed country.

And if you include markets like Taiwan and Hong Kong, the Greater China opportunity within emerging markets becomes even larger, or close to 60% of the MSCI Emerging Markets Index by market capitalization.

China's equity universe is large in scope but not entirely accessible

Breaking down China's equity share classes

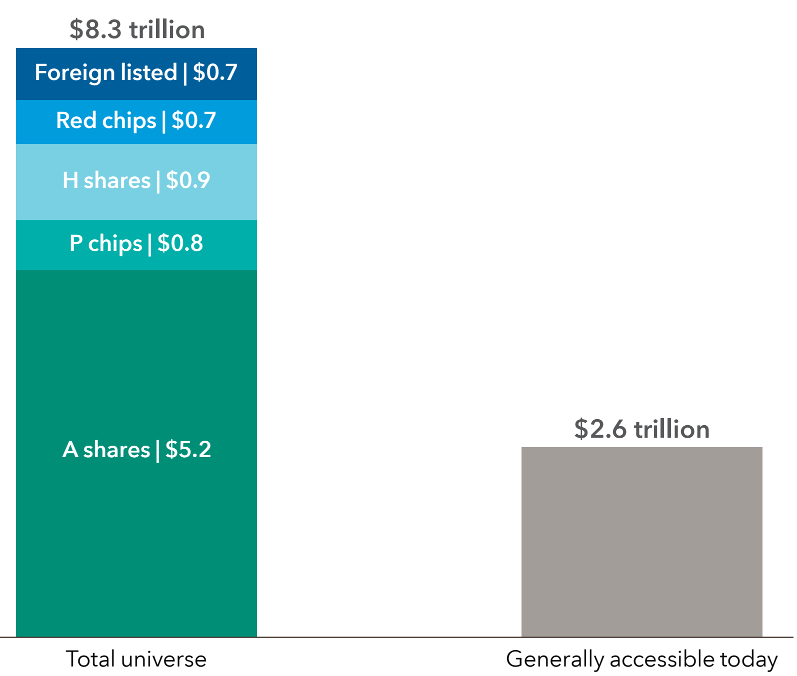
Foreign listed: Chinese companies incorporated outside China and traded on U.S. stock exchanges.

MSCI China Red Chip IMI: State-owned Chinese companies incorporated outside the mainland and traded on the Hong Kong Stock Exchange.

MSCI China H IMI: Companies incorporated in China that are traded on the Hong Kong Stock Exchange in Hong Kong dollars.

MSCI China P Chip IMI: Private sector companies incorporated outside China and traded on the Hong Kong Stock Exchange.

MSCI China A Onshore IMI: Chinese-incorporated companies trading on either the Shanghai or Shenzhen stock exchanges and traded in renminbi.



Sources: MSCI, RIMES. Data based on market capitalization as of 9/30/18.

Rob Lovelace
Portfolio Manager
Based in Los Angeles

"As the world's second-largest economy and stock market, China should start to be integrated into developed global stock market benchmarks such as the MSCI World and EAFE indexes," says portfolio manager Rob Lovelace. "China today is so different than other emerging markets. I think it makes sense to have an emerging markets ex-China index in order for other developing countries to get the appropriate attention they deserve. Otherwise, the opportunity set in emerging markets becomes skewed too much to China. Either way, getting China right from an investment perspective really matters. That's why we have been increasing the number of people in our Hong Kong and Beijing offices."

The changing face of Chinese equities

China is a large hunting ground, with more than 3,000 companies listed on the country's Shanghai and Shenzhen stock exchanges.

What's more, the domestic A-share market has many dynamic companies in the technology and consumer spaces. Alibaba and Tencent, whose shares are both listed in the U.S., have already become household names among many U.S. investors who've admired the fast growth of these internet and online shopping giants. Investors hope to find the next set of high-growth companies as they become available to foreign investors.

"A-share companies aren't well-known outside of China, and I believe that creates an advantage for investors like us who've been on the ground talking with management to understand their businesses," says portfolio manager Nick Grace. "I'm interested in a whole breed of new companies that are coming out in areas like artificial intelligence, machine learning and digital health care. I believe there could be some tremendous opportunities in these areas, and we should be well-positioned to identify them given our extensive bottom-up research."

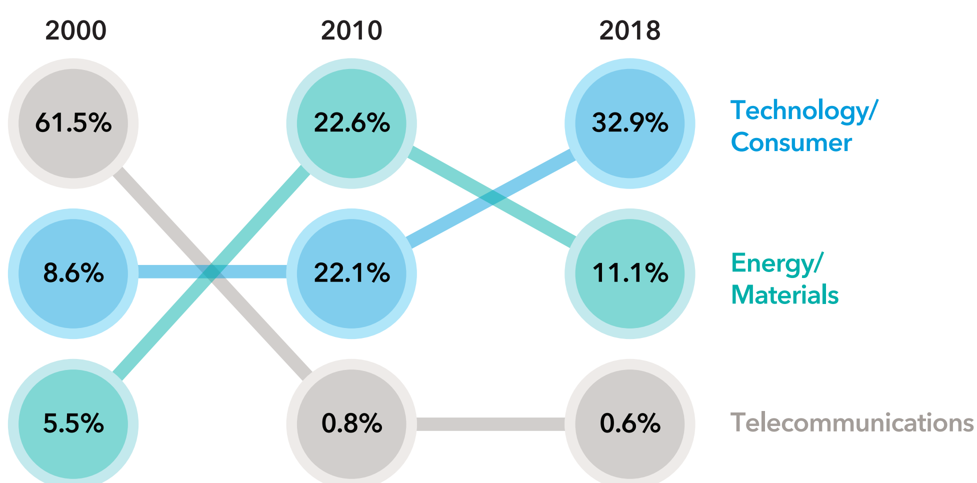
Helen Ding
Financials Specialist
Based in Beijing

Look beyond cultural differences

The cultural norms of corporate management in China can be different from what Western investors are used to. I met a chairman who burned through three cigarettes during the course of a one-hour meeting. And for every question we asked, he launched into a 10-minute monologue. But it was clear that behind the gruff exterior he had complete command of his business and industry.

I think this is typical of A-share management teams. They are capable executives who know their business but aren't experienced in meeting with investors. They don't know how to walk the walk *and* talk the talk. As investors, we shouldn't be deterred by the appearance of top management and conclude that these companies are not investible or have corporate governance issues just because they are different from the more polished management teams we see in developed markets. Rather, I think it can lead to opportunities for investors who do dig deeper to look through this murky market to find true gems.

A-share market reflects a dramatic shift to new-economy stocks



Sources: MSCI, RIMES. As of 6/30/18. Chart shows MSCI China A Onshore Index sector weights as of 12/31/00, 12/31/10 and 6/30/18.

Dickon Corrado
Investment Analyst
Based in Singapore

Thinking laterally

A-share companies can be creative in their pursuits. I met with a company that manufactures television panels and displays used in electronic devices. But it also turned out that through their political connections their new plan is to buy hospitals in cities where they operate their manufacturing plants. I asked them: What's the possible connection between flat screens and hospitals? They admitted there is none but explained that hospitals were worthwhile investments given China's aging and wealthier population. It's an example of how the Chinese think laterally. Western companies are more linear, focusing on a core business and how to execute the business plan to succeed in that market. This company ventured into a completely unrelated business line, without any visible link back to the core business, and with the strategy of figuring it out as they went along.

China's transition into a consumption-oriented society is changing the landscape for investors. As more people have bought homes, moved to major cities and connected through smartphones, the makeup of the MSCI China A Onshore Index has undergone a major facelift in just the past decade.

For instance, one of the index's leading constituents by market value is Ping An Insurance. In addition to selling insurance, the company is leveraging technology with online apps in real estate and health care. Another is Kweichow Moutai, one of the world's largest spirits makers. Others include Midea Group, a producer of household appliances, and Gree Electric Appliances, a manufacturer of air conditioners for homes and commercial buildings.

Collectively, companies in the information technology and consumer sectors constitute nearly 33% of the index compared with 9% in 2000.

"This transformation should only accelerate as China's economy continues to evolve to consumption-led growth," says portfolio manager Shaw Wagener. "The A-share universe is a rich market with some high-quality companies in a range of industries – especially in the consumer, health care and information technology sectors, where I have met with a number of listed firms that are globally competitive in the products they produce.

"This has happened in a relatively short period. The first time I visited Shenzhen, across the border from Hong Kong, was in 1994, and I had to travel there on a dirt road. Today Shenzhen is a bustling metropolitan area and key Chinese technology hub, similar to Silicon Valley."

Gauging the A-share universe

The A-share market is a sum of many parts. Its sheer size, regulatory environment and multiple corporate structures add layers of complexity that can be challenging to navigate. However, such complexities provide opportunities for investors who pick stocks on a company-by-company basis.

In researching the A-share market, we've found what motivates business choices and capital allocation decisions often depends on management and whether the company is state-run or private.

For example, large state-owned conglomerates in banking and energy tend to be politically driven and the CEOs are often government-appointed, while listed companies that don't have majority state-ownership are more focused on revenue growth and market share gains.

"Through my experience, I've found that A-share companies will aggressively invest money even with low or even negative returns if they believe it can eventually help them gain market share and build enough scale to take out the competition. In this sense, they are long term focused," says investment analyst Dickon Corrado.

Jerome Lang
Commodities Specialist
Based in Beijing

Investor communications for SOEs is improving

I remember 10 years ago how it was really awkward and uncomfortable to communicate with the management of state-owned-enterprises (SOEs). They didn't answer investors' questions directly and behaved like they were diplomats. In their minds, investors were like journalists, so the less they spoke, the safer it was for their personal reputation.

Furthermore, access to senior management was practically nonexistent, even for large shareholders. That's changing. Now, I feel some SOEs have become more sensitive to the concerns of foreign investors and are taking meetings and considering their suggestions. I see more younger executives who have studied outside of China. Of course, it's too early to say all SOEs have evolved in this respect, but I'm witnessing some positive changes.

Local retail investors can also influence share prices. They currently dominate trading in the A-share market and are more momentum-driven and short term in focus.

Furthermore, we've also found that many Chinese companies aren't run by Western-trained executives: they are often led either by government officials or entrepreneurs, each of whom have their own set of personal ambitions, not all of which may be related to managing a company. The key is to find shareholder-aligned management teams.

"There is also the worry about financial shenanigans. So I spend a lot of time studying balance sheets and cash flows and matching that with what I hear from customers and suppliers, along with my trust level of management," says Corrado. "I also learn by talking to their competitors. The Chinese can be very frank when talking about their competition. Along those lines, tapping my contacts in Japan helps me find out who they see as strong competitors in the A-share market, particularly as it relates to how advanced a company's technology is. By triangulating these views and matching that with accounting red flags, it can help us to avoid the pit-falls."

A stock picker's paradise

"I view China as a classic stock picker's market. It's a vast universe with a wide disparity in terms of the quality of companies in which to invest," says portfolio manager Winnie Kwan. "For instance, the small-and mid-cap universe is large, with close to 1,000 companies. The challenge is finding companies with the right management team and business models that I would want to invest in for the long term on behalf of our clients.

"There are a number of stocks that aren't attractive from a valuation or corporate governance standpoint. But, I do believe there's potential for some A-share companies to become much larger in market value, especially when I evaluate opportunities in areas of China's new economy."

In the A-share market, will there be another Tencent or Alibaba? Both now rank among the most valuable technology companies in the world and have arguably leapfrogged their Silicon Valley counterparts in the development of social media and mobile payment platforms.

Given China's trajectory, there appears to be promise.

Made in China 2025 may present opportunities

Some of the growth opportunities in the A-share market may emerge from the Made in China 2025 program, the government-sponsored campaign targeting major investment and business incentives in areas such as health care, industrial automation, semiconductors and clean energy.

While this initiative is a source of contention in China's relationship with the U.S. and other countries, Chinese leaders want their country to be more self-sufficient and become a high-tech powerhouse. Part of this strategy is to develop more national champions like Tencent and Alibaba that can compete with foreign multinationals.

Steve Watson
Portfolio Manager
Based in Hong Kong

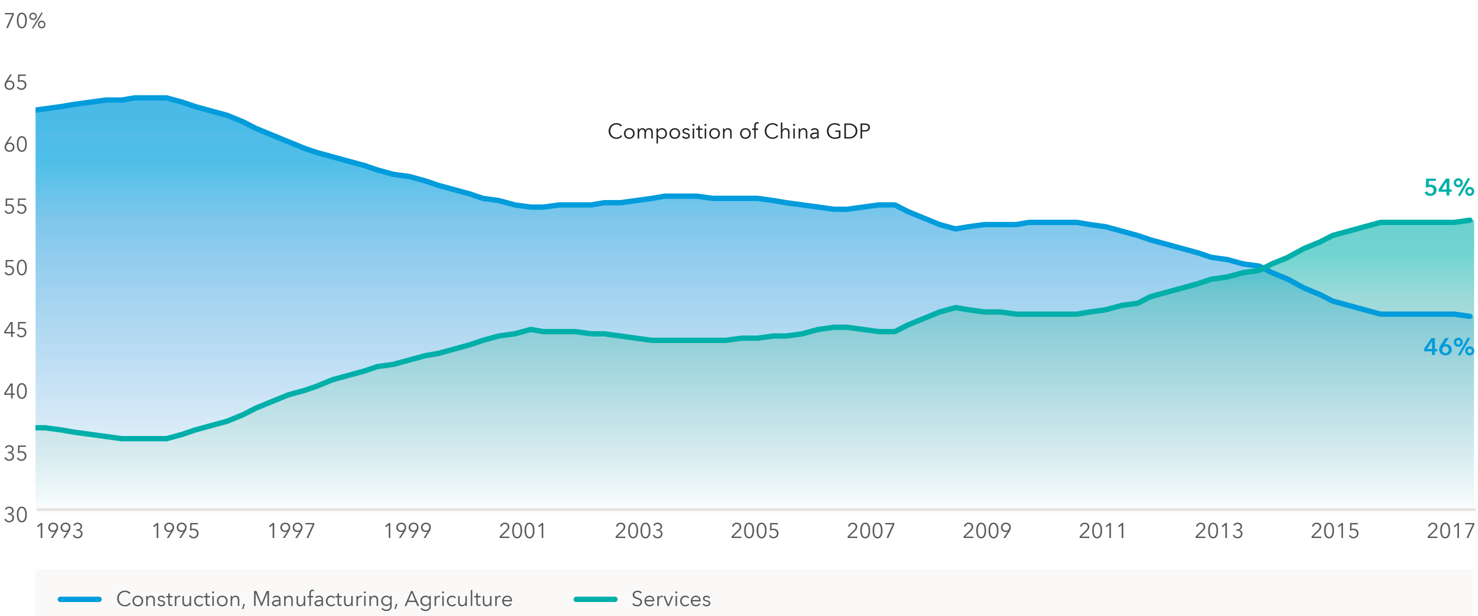
"Most Chinese companies I visit today are far savvier. Management teams are learning what we consider best governance practices and implementing changes."

Corporate governance standards should improve

There is hope that including more A-share companies in the MSCI indices will spur further liberalization of China's equity markets. As more foreign investment dollars pour into the A-share market, we could see regulatory authorities and mainland companies take further steps to conform to standards practiced by publicly traded firms and stock exchanges in developed markets.

"I met with a company in Shanghai in 1995 that eventually went public on the Hong Kong exchange," recalls portfolio manager Steve Watson. "Management sat stone-faced as their colleague droned out 10 years of financial numbers. When he was done, I asked why revenues had increased every year but profits had declined. No one was able to answer the question — they clearly had not thought about it.

China's ongoing shift to a services-oriented economy



Sources: China National Bureau of Statistics, Thomson Reuters. Chart shows average of the trailing four quarters. As of 6/30/18.

Tracy Wang
China consumer industry specialist
Based in Beijing

Reading the fine print

It may come as surprise, but in the course of my research I've found A-share companies can disclose more detailed information in their filings than Chinese companies that are listed in Hong Kong.

Here are some of the areas:

- Stocks pledged by major shareholders.
- Income from riskier wealth management products.
- Revenue from key customers and suppliers.
- Related party transactions.

A large team dedicated to China

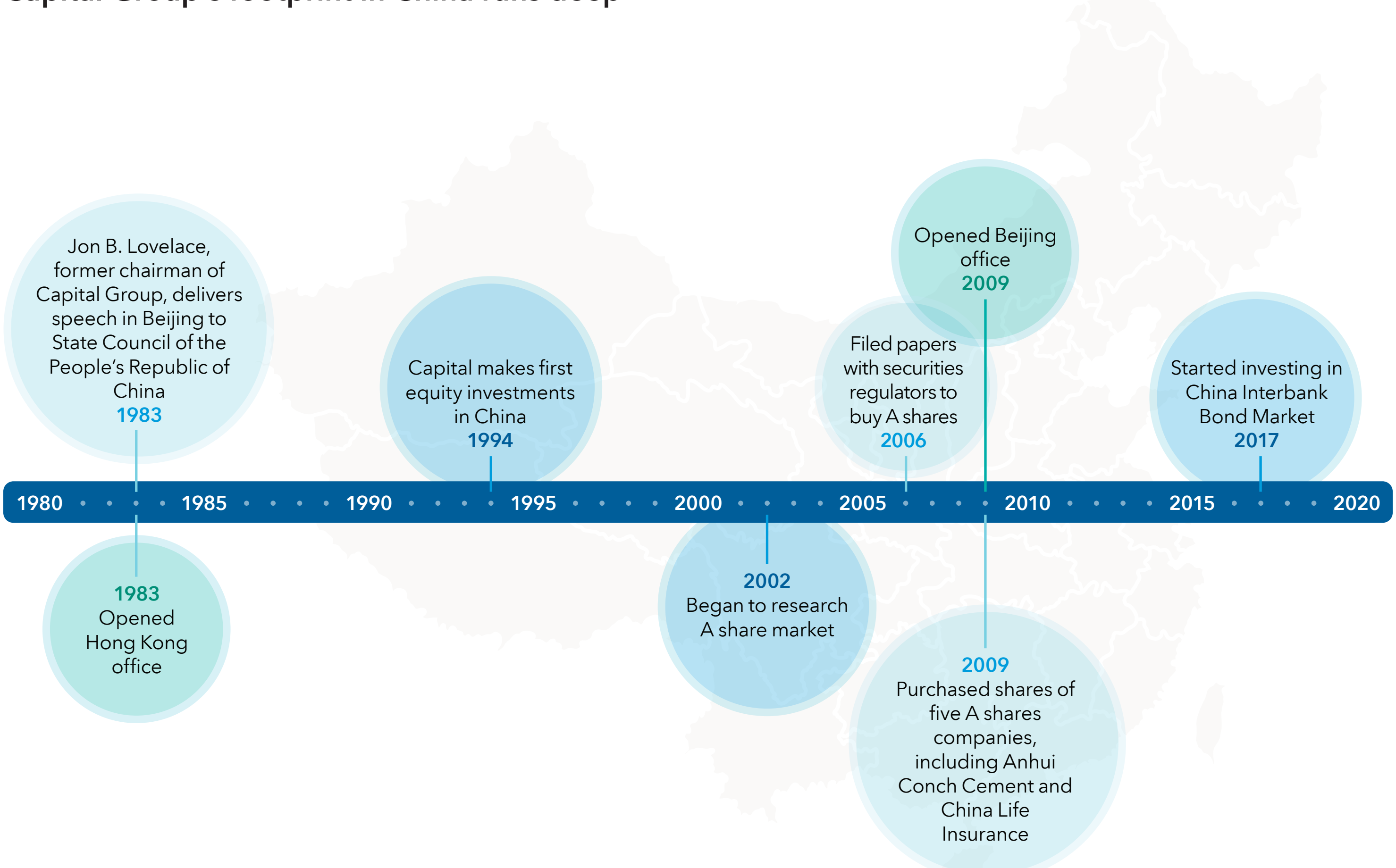
Capital has a long history of investing in Chinese stocks. We currently have more than three dozen analysts, portfolio managers and economists directly focused on China, many of them fluent in Mandarin. Areas of focus for analysts include companies involved in technology, finance, health care, consumer products and commodities.

Among those supporting our efforts in Beijing are seven China specialists.

They spend much of their time visiting A-share companies and meeting with a broad network of local industry and government contacts to source differentiated industry research to Capital's investment analysts.

"The team is diving deeper into their areas of coverage to scope out the high-quality interesting companies in their respective industries," says China Affairs Director Susan Dietz-Henderson. "Being able to lift the curtain and analyze these companies in a systematic way is of immense value to our decision-making process."

Capital Group's footprint in China runs deep



Source: Capital Group.