

Foundations of Dedicated China Allocations: Part 4

Understanding drivers of excess returns

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Executive summary

In 2019 and 2020, the MSCI China Index significantly outperformed other emerging markets, posting annual returns of 24% and 30%, respectively.¹ But over the next three years, performance dipped as the China equity market became more volatile amid domestic macroeconomic realignments and global geopolitical uncertainty.

Since 2021, some institutional investors have reduced their China equity exposure, anticipating continued underperformance of the world's second-largest equity market amid concerns over geopolitical risk. Others have adopted [a dedicated China allocation](#), believing in the potential merits of such an approach.

Interestingly, although the MSCI China and MSCI China A Indexes were down 18% and 13%, respectively, on an annualized basis from 2021 to 2023, some dedicated China funds generated double-digit annualized total returns, shrugging off the negative externalities of the macro environment and fund flows. How, then, did some active and factor-based strategies deliver significant excess returns in the China market? And if systematic frictions persist, how might investors localize their investment framework as they seek to harvest the potential diversification benefits of a dedicated China approach?

To address these questions, we propose a simple three-layer framework to help demystify potential drivers of excess returns in the China market. The proposed framework could be relevant for investors who have already adopted (or are about to adopt) a dedicated approach to China allocation. Furthermore, investors transitioning to a total portfolio approach,² even without a dedicated China strategy, may find the framework useful to bring transparency to a macro- or micro-based investment thesis on China exposures.

¹ Gross returns in USD, unless otherwise stated.

² The total portfolio approach (TPA) is a holistic approach to investing that has been adopted by an increasing number of institutional investors. With its focus on a single investment objective for managing a portfolio of assets as well as the governance and cultural considerations that are attached to it, it has been designed for institutions that need to target specific investment objectives (TAZÉ-BERNARD and GERMANO, 2020)

Introduction

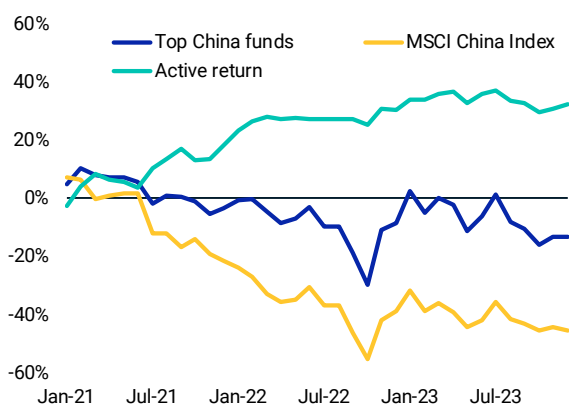
Despite the headwinds faced by the China equity market from 2021 through 2023, some active and factor-based funds outperformed their market-capitalization-weighted benchmark indexes. Furthermore, select top-performing China mutual funds were able to earn double-digit annualized total returns, while the overall China market was down significantly. This live track record indicates that certain active or factor-based strategies may indeed have possessed the ability to generate substantial excess returns compared to the overall China equity market.³ The rest of this paper is devoted to gaining an understanding of the potential key drivers of excess return in the China equity market.

Excess returns of dedicated China funds

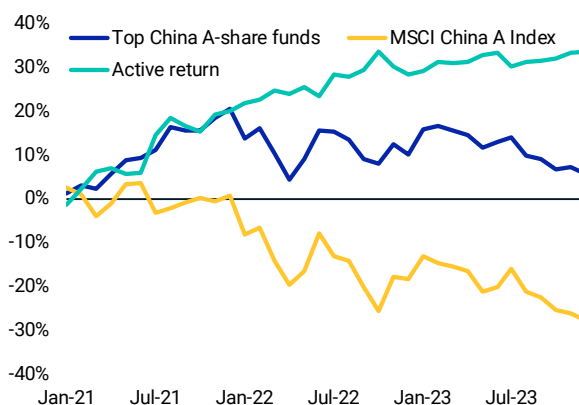
We examined the top-performing dedicated China mutual funds over the period from 2021 through 2023.⁴ We screened top performers from two groups of universes: funds that can invest in the broad China market, including both onshore and offshore China equity markets (“China funds”),⁵ and China-mainland funds, encompassing equity and hybrid funds, that primarily focus on the onshore A-share market (“China A-share funds”).⁶ We use the MSCI China and MSCI China A Indexes, respectively, as the groups’ benchmarks for our analysis.

Exhibit 1: Cumulative performance of top-performing dedicated China funds

Panel A: China funds



Panel B: China A-share funds



Data period is from January 2021 through December 2023. The top China funds include the top five performers of dedicated China funds in the Hong Kong market, and the top China A-share funds include the top 10% of best performers of China-mainland mutual funds. Source: Wind, MSCI Global Research.

³ We show the performance analysis of dedicated China funds during the 2018-2020 period in Appendix A for comparison purposes.

⁴ Our analysis of the top-performing dedicated China funds may not cover all the top-performing funds in the global market due to constraints on data availability, but it demonstrates examples of top performers. Our results roughly reflect the characteristics of the overall China market from 2021 through 2023.

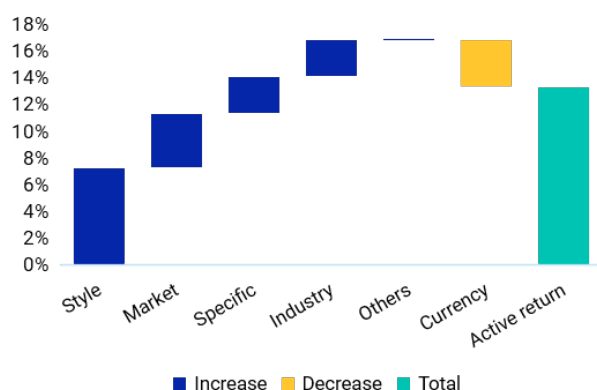
⁵ Due to data availability for the funds, the China fund universe was drawn solely from dedicated China mutual funds in the Hong Kong market, which resulted in 89 funds for the analysis period 2021-2023. Passive funds were excluded from the analysis.

⁶ The universe of China A-share funds included equity funds and hybrid funds (aggressive-allocation funds, balanced funds and flexible-allocation funds) in the mainland market, resulting in about 2,800 funds for the analysis period 2021-2023. We excluded indexed and enhanced indexed funds from our analysis.

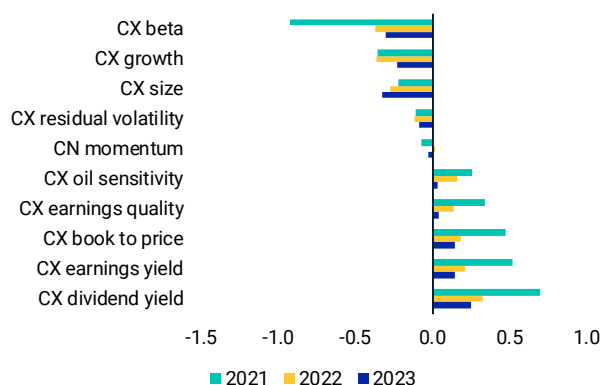
Both groups of top-performing funds delivered an annualized excess return of 10% over the three-year study period,⁷ but their performance attributions differed. The top China funds' largest excess-return contributor was the style factor, followed by the market, specific and industry factors. These funds had greater active exposure to the high-dividend-yield and value factors in the offshore China market, as well as low active exposure to beta and growth and large-cap stocks. These exposures combined helped provide some performance resilience amid market turbulence.

Exhibit 2: Performance attribution and style exposure of top China funds

Panel A: Performance attribution



Panel B: Active style exposure

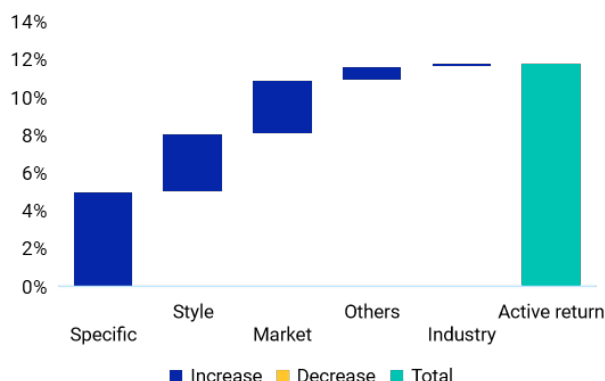


Based on data from January 2021 through December 2023. Based on output from the MSCI Multi-Asset Class Factor Model (MAC.L), which covers the China Equity Model (estimation universe being all China A shares), represented as "CN" in panel B, and the China International Model, represented as "CX" in panel B. Base currency is USD. Source: Wind, MSCI Global Research.

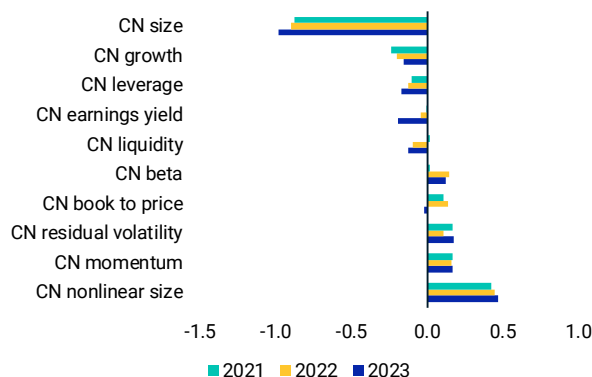
The top China A-share funds' excess return was primarily attributable to asset-specific return, but the style and market factors also contributed considerably. Specifically, they had large active exposures to small-cap and midcap stocks in the China A-share market.

Exhibit 3: Performance attribution and style exposure of top China A-share funds

Panel A: Performance attribution



Panel B: Active style exposure



Based on data from January 2021 through December 2023. Based on the MSCI MAC.L model. Base currency is CNY. Source: Wind, MSCI Global Research.

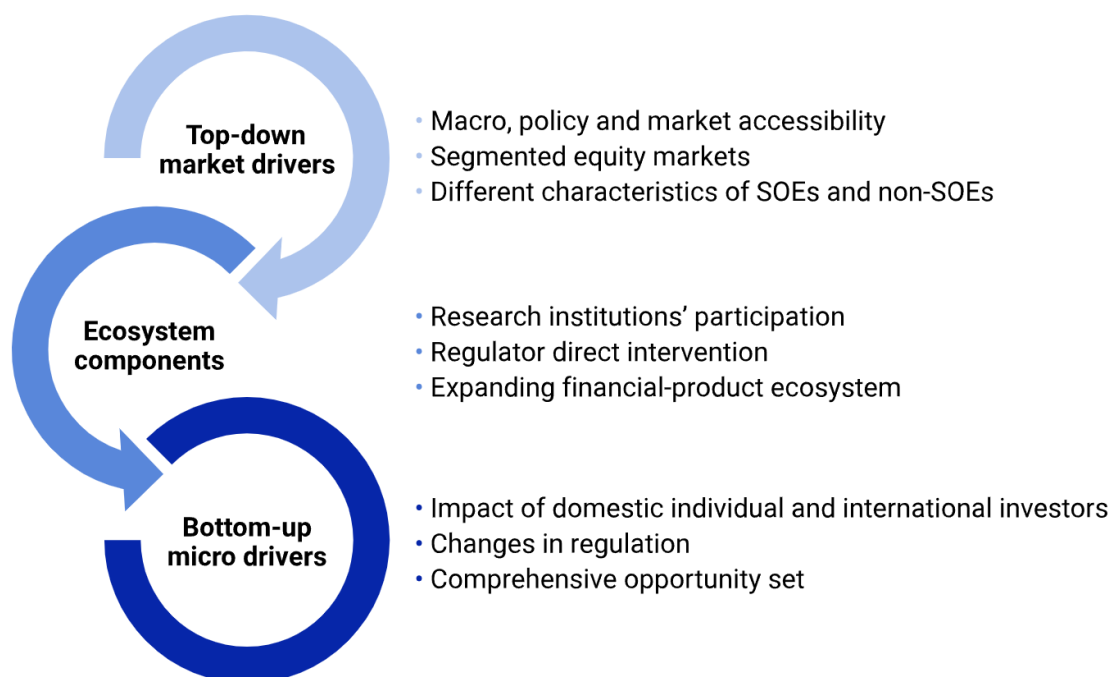
⁷ The performance analysis of the top-performing China funds is aggregated based on the assets under management of each fund.

Framework for understanding excess-return drivers

China's equity market, younger than other global equity markets, has evolved on many fronts, including the structure of market participants, what financial products are available and the regulation that governs them. On the one hand, the combination of some of its idiosyncratic features, such as segmentation and micro dynamics, could provide opportunities for global investors who have sufficient local insight and understand its market mechanisms. On the other hand, such complexities could pose challenges for investors following a one-size-fits-all global investment approach.

To help investors pursuing a dedicated China allocation (including the evaluation and selection of dedicated managers) gain a better understanding of the local environment, we propose a framework that encompasses three categories of excess-return drivers: top-down, bottom-up and ecosystem. These drivers – affected by factors such as the size of the market, the pace at which the market is opening, the regulatory environment and Chinese households' investing behavior – can be viewed as fluid. Therefore, investors with a dedicated China allocation may wish to pay ongoing attention to these forces and how they may change over time.

Exhibit 4: A framework to understand distinctive excess return drivers in the China equity market



Top-down drivers: Macro and market segmentation

We begin with a look at the Chinese equity market from the top down. Because the overall market is composed of onshore A shares and securities traded offshore in Hong Kong and other markets, participants must juggle multiple factors, requirements and influences in choosing which segment of the market to invest in. Four of the most important considerations are:

- The need to comply with rules of multiple regulatory bodies, depending on the listing market and security type.
- The allocation considerations, for example, the applicable risk-free rate and risk premium requirement based on the funding sources and costs in the investor's home market. Investment policy and portfolio construction, considering investment objectives, time horizon, liquidity sensitivity and geographic allocation, can also influence the investment decision (Wei, Xu and Xu 2021a ,b).
- The specific approach for valuing shares and the regulations of the onshore and offshore segments, which can affect companies' decisions about where to list their securities and how they structure corporate actions after listing; these decisions may, in turn, impact investors' investment decisions.
- The transmission mechanism of domestic macro policies, such as monetary policy, which varies for securities listed in onshore versus offshore markets due to different investor bases as well as constraints for cross-border capital flows.

Regulation, investment policy and market accessibility

The China onshore and offshore markets are governed by their own regulatory bodies and thus have different regulatory frameworks and rules. The China Securities Regulatory Commission (CSRC) and the National Financial Regulatory Administration supervise and regulate the onshore market's securities sector and financial industry (except the securities sector), respectively. In the Hong Kong market, the Securities and Futures Commission of Hong Kong is the main regulatory body for the securities and futures markets. The exchanges also monitor and regulate issuers and investors. Investment-industry associations also play a part in overseeing and providing compliance guidance for market participants. Each market's regulations have profound implications on a listed company's business and ownership structure, investor base, market mechanism and policy transmission.

Changes in regulation and economic and industry policies have the potential to impact multiple components of the market's drivers. Wei, Xu and Xu (2021c) demonstrated, using a top-down return decomposition, that from December 2001 to June 2021, the performance of China's equity markets, represented by the MSCI China and MSCI China A Indexes, was primarily driven by growth in sales per share. The next most important driver was dividend return, whereas change in profit margin was a slightly negative contributor for both indexes. Valuation changes contributed negatively to the MSCI China A Index, but were a positive contributor to the MSCI China Index. As in the case of valuation, the onshore and offshore markets plausibly can have different reactions to changes; for example, looser domestic monetary policy is likelier to more directly influence the risk-free rate of the onshore A-share market.

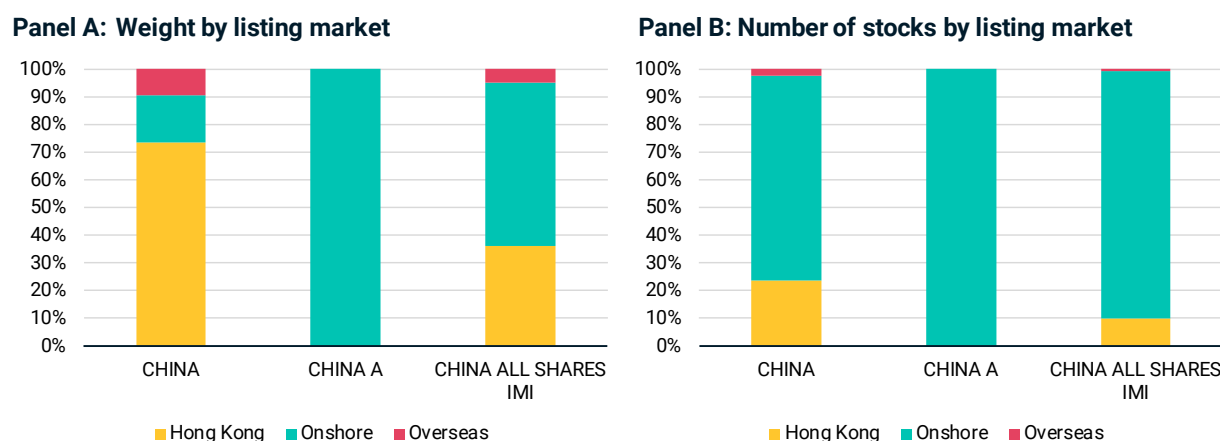
Market accessibility is another key consideration for investors. Since China launched the Stock Connect scheme in 2014 and emerging-markets indexes began including A shares in 2018, global investors' accessibility to Chinese equities has markedly improved. Full accessibility to the A-share

market will require more progress, however, in terms of foreign-ownership limits, securities lending and short-selling as well as clearing and settlement practices (see the June 2023 [MSCI Global Market Accessibility Review](#) for more details).

Segmented listed equity markets

Market segmentation is a distinctive characteristic of China's listed equities. Each of the three markets — onshore, Hong Kong and overseas — encompasses its own liquidity dynamics, varied macroeconomic drivers, investor risk appetite and regulations, and offers an investable opportunity set different from the others.

Exhibit 1: MSCI China Indexes' composition by listing market

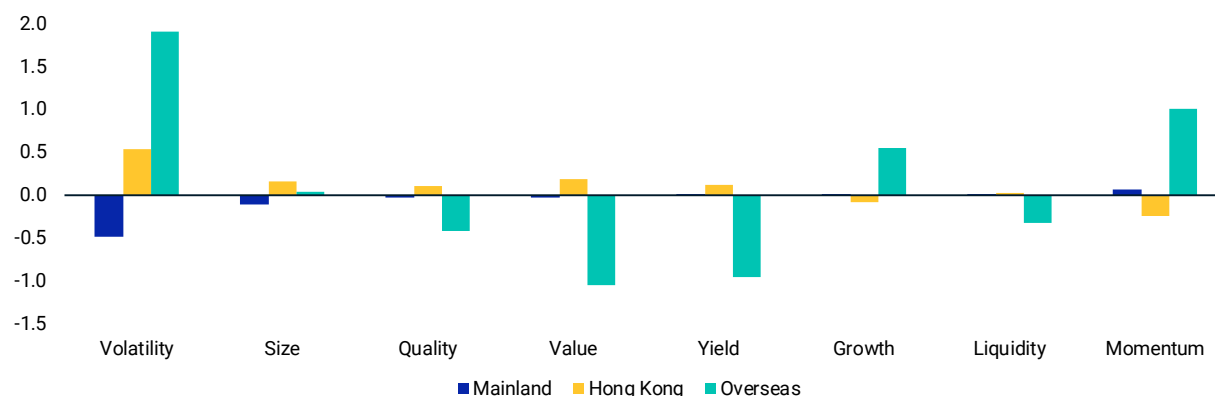


Data as of Dec. 29, 2023. The indexes are the MSCI China and MSCI China A Indexes and the MSCI China All Shares Investable Market Index (IMI).

As a result, the three markets have developed different style-factor characteristics. The MSCI FaCS framework shows that, compared to the A-share market, the Hong Kong and overseas markets have higher volatility exposure because they could have been more directly influenced by global liquidity swings and geopolitical tensions. The nature of their respective listed companies and investor structures have likely contributed to Hong Kong's higher active exposure to the size, quality, value and yield factors and the overseas market's notably higher exposure to the growth and momentum factors.⁸

⁸ For the Shanghai Stock Exchange (SSE), Shenzhen Stock Exchange (SZSE) and Beijing Stock Exchange (BSE), different sector and company compositions could lead to their having different style and risk characteristics. For example, the SSE's three largest sectors (in size order), by weight in the MSCI China All Shares IMI, were financials, industrials and information technology and the SZSE's three largest sectors (in size order) were information technology, industrials and materials as of Dec. 29, 2023.

Exhibit 2: Active exposure of MSCI China All Shares IMI by listing market



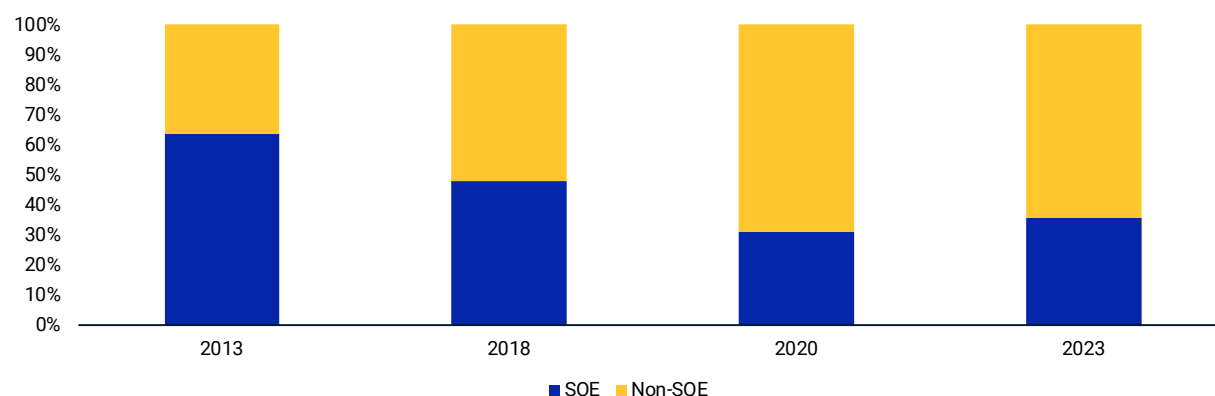
Data as of Dec. 29, 2023. Based on the Barra Global Total Market Equity Model for Long-term Investors (GEMTLT). The benchmark is the MSCI China All Shares Investable Market Index (IMI).

SOEs' and non-SOEs' contribution to diverse style exposures

At the end of 2013, state-owned enterprises (SOEs) composed over 60%, by weight, of the MSCI China All Shares Investable Market Index (IMI). Their weight had declined to 35% by the end of 2023, following SOE reforms and more non-SOEs entering the capital market.

In aggregate, SOEs and non-SOEs display different style exposures. As of Dec. 29, 2023, SOEs had higher active exposures to the yield, value, quality, momentum and size factors,⁹ while non-SOEs had higher exposures to the growth, liquidity and volatility factors.

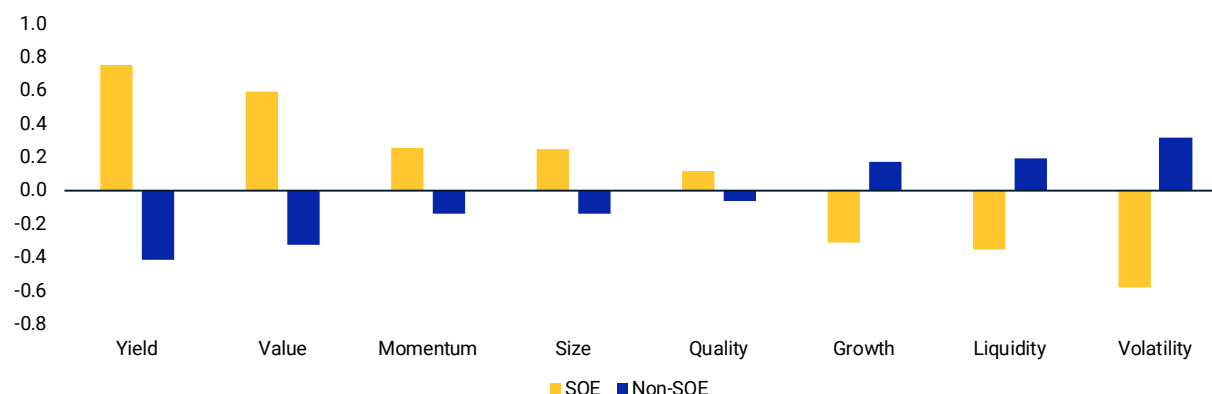
Exhibit 3: Weights of SOEs and non-SOEs in MSCI China All Shares IMI



Data as of Dec. 29, 2023. Based on the GEMTLT model. The benchmark is the MSCI China All Shares Investable Market Index (IMI). Source: Wind, MSCI

⁹ SOEs' higher active exposure to the quality factor, relative to that of non-SOEs, was mainly attributable to higher active exposure to investment quality and lower active exposure to earnings variability.

Exhibit 4: Active exposures of MSCI China All Shares IMI by ownership



Data as of Dec. 29, 2023. Based on GEMTL model. The benchmark is the MSCI China All Shares Investable Market Index (IMI). Source: Wind, MSCI

Bottom-up drivers: Market micro-structure and investors

Bottom-up drivers, such as the large opportunity set representative of a wide range of sub-industries and emerging themes, evolving investor structure and regulations, contribute to the distinctiveness of the China market and the potential drivers of excess returns.

Comprehensive opportunity set

As of Mar. 29, 2024, the MSCI China All Shares IMI comprised over 3,900 stocks with an aggregate free-float market-cap of over USD 3.9 trillion and covered 87% of the Global Industry Classification Standard (GICS®)¹⁰ sectors level-four sub-industries,¹¹ with 28 stocks, on average, in each sub-industry.¹² This degree of depth compares favorably with leading emerging markets and the U.S. equity market.

¹⁰ GICS is the global industry classification standard jointly developed by MSCI and S&P Global Market Intelligence.

¹¹ The [GICS framework](#) has four levels: 1) 11 sectors, 2) 25 industry groups, 3) 74 industries and 4) 163 sub-industries.

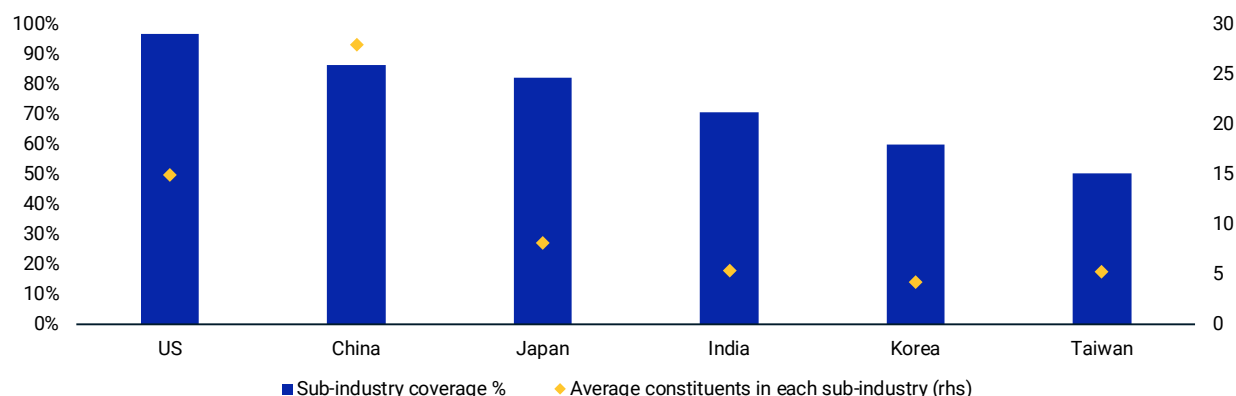
¹² C-REITs are not eligible for inclusion, while in other markets, REITs are generally eligible. This could partially explain the missed sub-industry coverage of the MSCI China All Shares IMI.

Exhibit 5: Number of stocks and market-cap of key regional markets

Number of constituents	MSCI China All Shares IMI	MSCI USA IMI	MSCI Japan IMI	MSCI India IMI	MSCI Taiwan IMI	MSCI Korea IMI
Total	3,944	2,378	1,092	621	435	417
Information technology	756	300	134	37	188	69
Industrials	909	379	272	129	58	88
Materials	600	112	104	112	51	53
Health care	438	361	66	55	23	54
Consumer staples	224	103	101	36	16	30
Consumer discretionary	431	280	173	95	44	49
Utilities	106	67	20	19	2	2
Financials	135	410	92	92	34	32
Communication services	149	103	46	17	6	30
Real estate	132	148	74	18	12	5
Energy	64	115	10	11	1	5
Free-float market-cap (USD bil.)	MSCI China All Shares IMI	MSCI USA IMI	MSCI Japan IMI	MSCI India IMI	MSCI Taiwan IMI	MSCI Korea IMI
Total	3,942	50,716	4,918	1,583	1,551	1,090
Information technology	467	14,172	720	173	1,126	482
Industrials	485	5,085	1,115	184	69	157
Materials	340	1,349	285	149	68	76
Health care	285	6,222	347	101	14	80
Consumer staples	317	2,867	296	110	24	26
Consumer discretionary	715	5,454	936	206	43	94
Utilities	128	1,093	65	67	1	5
Financials	551	6,792	611	370	166	99
Communication services	437	4,231	298	48	30	58
Real estate	86	1,371	200	28	8	2
Energy	131	2,081	45	146	2	11

Data as of Mar. 29, 2024.

Exhibit 6: GICS level-four sub-industry coverage of key markets



Data as of Mar. 29, 2024. The [GICS framework](#) has four levels: 1) 11 sectors, 2) 25 industry groups, 3) 74 industries and 4) 163 sub-industries. Markets are represented by the MSCI USA, MSCI China All Shares, MSCI Japan, MSCI India, MSCI Korea and MSCI Taiwan Investable Market Indexes.

The China market also offers exposure to popular structural megatrends that many believe capture the dynamic forces shaping the future of the world. These megatrends fall into four broad categories: the environment and resources, transformative technologies, health and health care and society and lifestyle. Chinese equities contributed around 20% of the global markets' investable names in themes such as clean-energy infrastructure, future education, future mobility, efficient energy and immuno-oncology.

Exhibit 7: Thematic exposure of selected regional markets



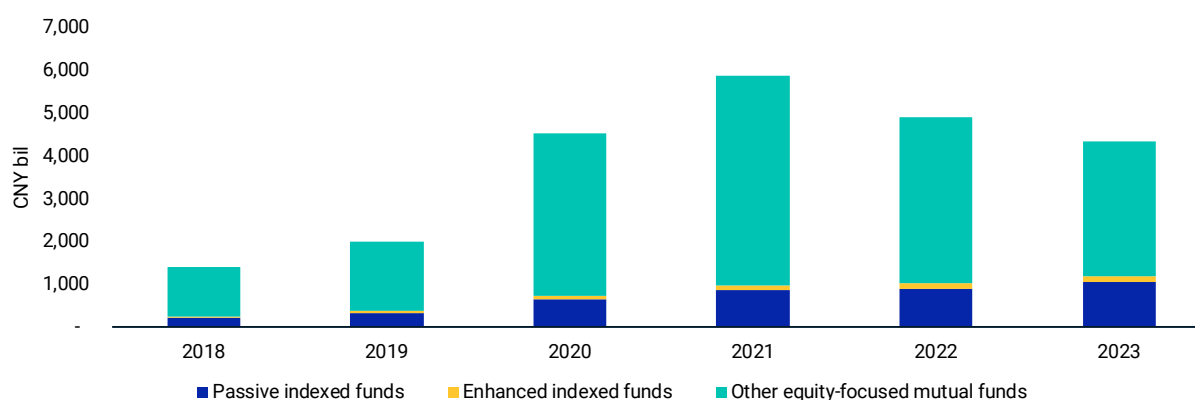
Data as of Jan. 31, 2024. Based on the MSCI ACWI IMI thematic indexes.

Strong participation by retail investors

The A-share market has long been known for the strong presence of retail investors, and the avenues for retail participation have become more diversified in recent years. Although share of individual investors in A-share trading declined to about 60% in 2022¹³ from about 80% in 2019, their level of direct participation remains higher than in most global markets.¹⁴

Individual investors also increased their indirect participation through investing and trading in mutual funds. The CAGR of assets under management (AUM) held by individual investors in mainland equity-focused mutual funds expanded by about 25% to CNY 4.3 trillion from year-end 2019 through year-end 2023. The net subscription and redemption activities of retail investors in indexed, sector and thematic funds may affect the underlying stocks' performance.

Exhibit 8: Individual investors' holdings in equity-focused mutual funds



Data period is from December 2018 through December 2023. Equity-focused mutual funds include equity mutual funds and hybrid funds (including those with aggressive, balanced and flexible allocations). Source: Wind, MSCI

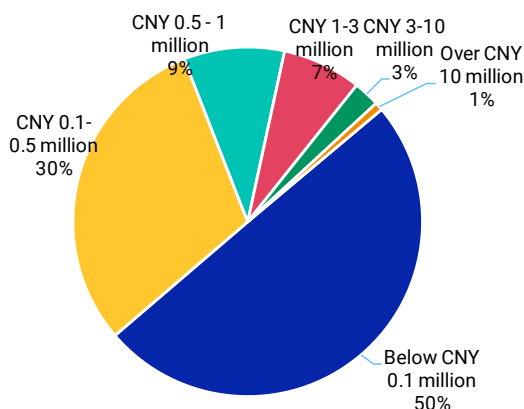
Individual investors are not investing in a homogeneous fashion, as illustrated by account data provided by the Shanghai Stock Exchange (SSE). Less-sophisticated mass-market retail investors and more-sophisticated high-net-worth investors tend to engage in different investing behaviors given their range of resources and varying access to investment vehicles.

¹³ [Securities regulator details construction of modern capital market with Chinese characteristics \(www.gov.cn\)](http://www.gov.cn)

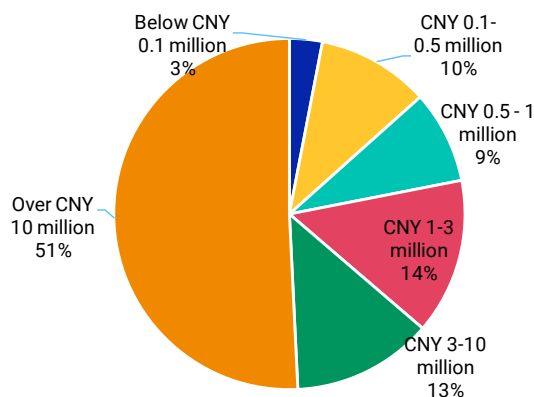
¹⁴ According to a survey of 34 exchanges conducted in early 2021 by the World Federation of Exchanges, about 70% reported retail's contribution to turnover was below 60%. Some exchanges, such as the SZSE, Dhaka Stock Exchange, Saudi Stock Exchange (Tadawul) and Taipei Exchange reported around 80% retail participation in trading volume in 2020 (Gurrola-Perez, Lin and Speth 2022).

Exhibit 9: Individual-investor holdings by size at Shanghai Stock Exchange

Panel A: Number of accounts



Panel B: Total holding of stocks in SSE



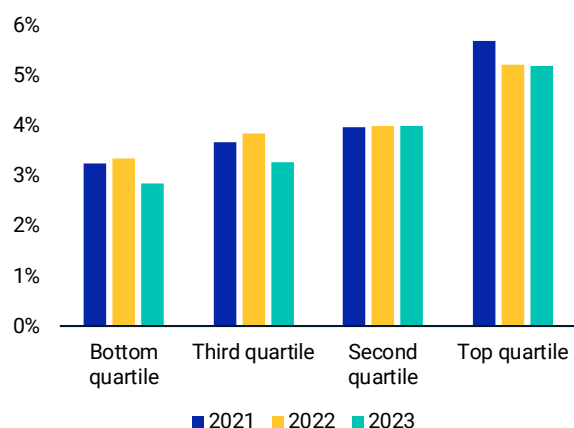
Data as of Dec. 31, 2022. Source: SSE, MSCI

Academic and industry practitioners have conducted numerous studies on retail investors' behavior in the China market, especially in the A-share market. We identified the following key representative characteristics:

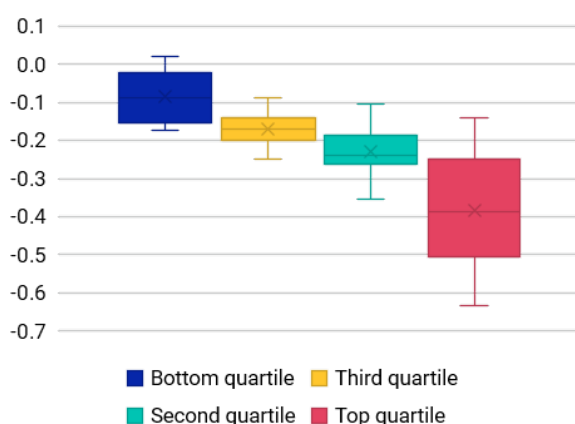
- **Higher daily turnover**, as shown in panel A of Exhibit 14.
- **Holding a high number of stocks with poor analyst sentiment on fundamentals**, as illustrated in panel B of Exhibit 14. Stocks with higher individual-investor ownership in the A-share market generally had poorer analyst sentiment, according to MSCI FactorLab data. This phenomenon could have two possible explanations. First, individual investors, unlike institutional investors, may place less emphasis on fundamentals. Second, individual investors may lack the resources of institutional investors to follow the latest changes in fundamentals.
- **Overinterpretation of the latest public news**. Chinese retail investors tend to overanalyze publicly available data and news information in an attempt to develop unique insights (Gurrola-Perez, Lin and Speth 2022).
- **Underdiversification**. Some Chinese retail investors have been observed to hold only a few different companies' stocks (Gurrola-Perez, Lin and Speth 2022). According to data from Wind, as of June 30, 2023, top-quartile individual-investor-held A shares were more concentrated in the industrials, information-technology and materials sectors, as measured by number of companies, and less balanced across the sectors compared to top institutional-investor-held A shares.
- **Herding**. Uninformed investors tend to herd more than informed investors in the China market, which could put pressure on a stock's price to deviate away from its underlying fundamentals (Liu et al. 2023).
- **Momentum trading**. Chinese retail investors have tended to add leverage in a bull market. The relationship between the number of new margin accounts opened by individual investors and A-share market performance, as shown in Exhibit 15, illustrates this phenomenon.

Exhibit 10: A shares by individual ownership

Panel A: Average daily turnover ratio

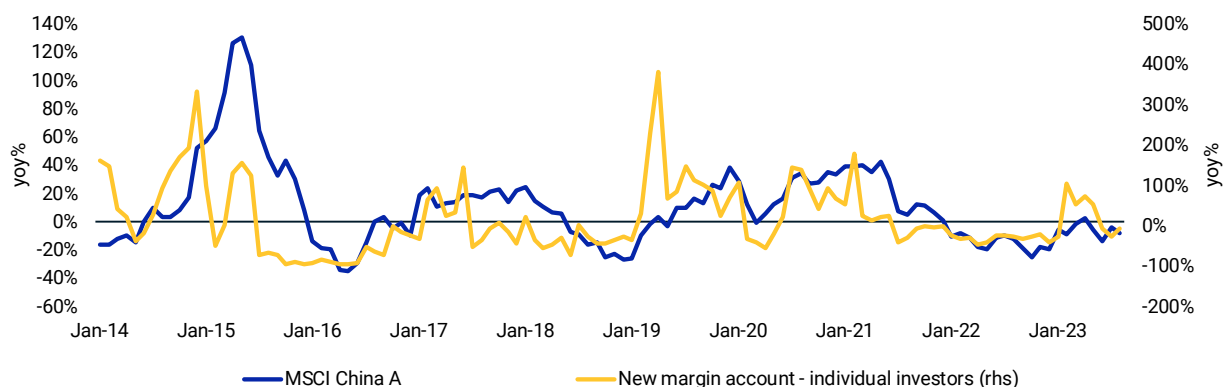


Panel B: Average analyst sentiment



Data period is from January 2021 through December 2023. The quartile groups are divided based on institutional investors' share in float A shares on June 30 of each year. The daily turnover ratio is calculated as daily traded volume divided by free-float number of shares. Analyst sentiment is the monthly change in analyst predicted earnings per share standardized within the China stock universe. Source: Wind, MSCI

Exhibit 11: New margin accounts and MSCI China A Index performance



Data period is from January 2014 through August 2023. Source: SSE, SZSE, MSCI

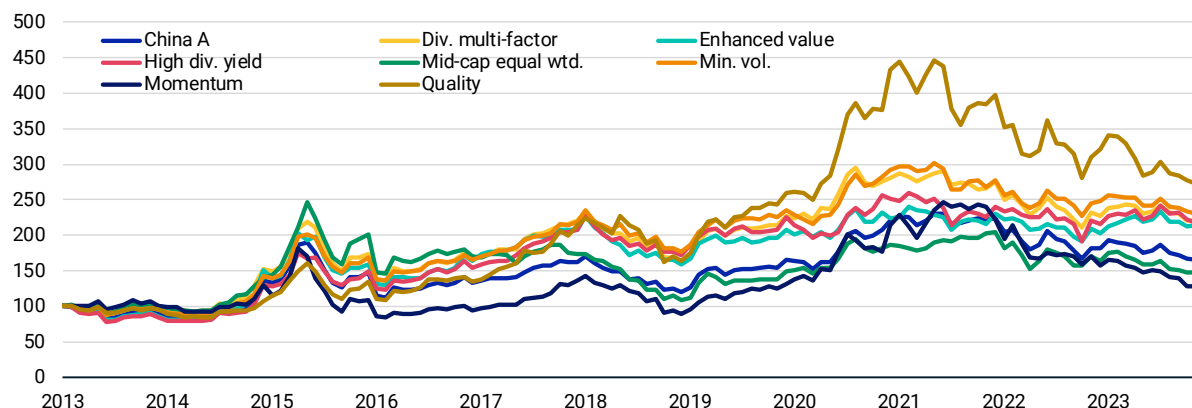
Increased participation by international investors

With the opening of China's domestic capital markets and A shares' inclusion in global equity benchmarks, international investors have noticeably expanded their participation in the A-share market. The annual turnover of China's Northbound Stock Connect — a major channel for Hong Kong and overseas investors to trade in A shares — increased 17 fold from 2015 to 2023. The increasing international investor participation in A-share market, introducing an incremental liquidity source, could have structural implications for the market.

One such implication could be factor performance. For example, the A-share quality factor performed well from 2019 through the first half of 2021, but by the end of 2023 had begun to retreat. Changes in international investors' holdings of quality stocks could have contributed to these

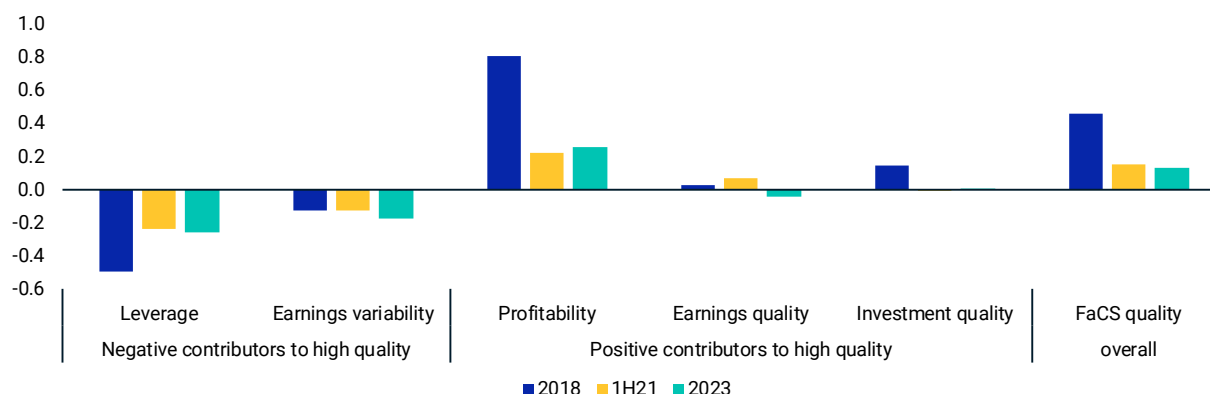
variations in the factor's performance. At the end of 2018, Stock Connect Northbound holdings had a strong positive active exposure to the quality factor, but by June 2021 – the peak level of the factor's performance in the A-share market – such exposure had dropped markedly and had slightly fallen further as of December 2023.

Exhibit 12: Factor index performance in China A shares



Data period is from Jan. 31, 2013, to Dec. 29, 2023. Factors are for the MSCI China A Index.

Exhibit 13: Active exposure of Northbound Stock Connect holdings to quality factors



Data as of Dec. 31, 2018, June 30, 2021, and Dec. 29, 2023. Based on the Barra China A Total Market Equity Model for Long-Term Investors (CNLTL model). The benchmark is the MSCI China A Index.

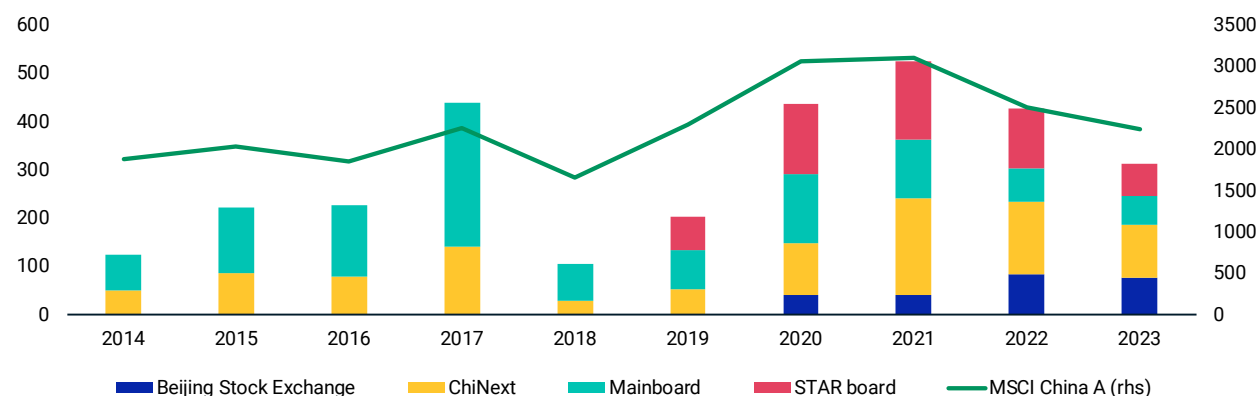
Another example of how [Stock Connect Northbound trading flows](#) appear to echo sector performance in the A-share market is a case study over the period from August to December 2023. During these months, financials and consumer-staples stocks faced strong selling pressure from Northbound investors. These sectors underperformed sectors that faced less selling pressure, such as health care and utilities, in the five months ending December 2023.

IPO investments and activities

Initial public offering (IPO) activities in the A-share market previously faced intense regulatory intervention, particularly in the pace of new listings and pricing. As Chinese regulators advanced IPO

reforms, including the launch of registration-based IPO reform and development of multilayered capital markets, new stock supplies in the A-share market expanded after 2019.¹⁵

Exhibit 14: IPO issuance in the A-share market



Data period is from January 2014 through December 2023. The index level for the MSCI China A Index are stated in CNY at each year-end. Source: Wind, MSCI

A-share IPOs have tended to be pro-cyclical in nature, that is, more financing activity typically occurs during bull markets versus bear markets as a result of market demand and regulatory controls.¹⁶ Higher levels of IPO activity could have two implications — one short term, another long term — for A shares' liquidity.

In the short term, especially in bear markets, large IPOs may weigh on near-term market liquidity. In the long term, if IPOs increase the supply of high-quality companies, this could encourage more active trading and greater liquidity. If, however, they increase the supply of poor-quality companies, such as companies with an obsolete business model, poor financial performance or weak corporate governance, this could hurt investor confidence and lead to the misallocation of capital. This risk would likely be magnified if effective regulation and a mechanism for investor protection and delisting are not in place. Regulators have therefore been working to enhance investor protections, refining rules regarding corporate actions and selling activities by major shareholders as well as imposing harsher punishment on fraudulent activities.¹⁷

IPO investments can no longer be considered low-hanging fruit because the abolition of IPO pricing limits and more-relaxed limits on post-IPO performance have led to more volatile returns for IPO investors. Over the last three years, some IPOs have posted negative returns on their debut days.

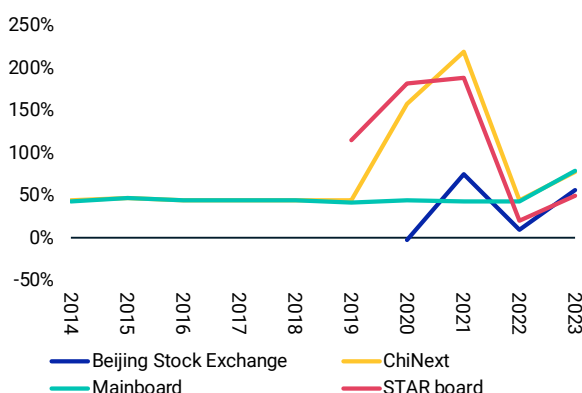
¹⁵ Registration-based IPOs were first launched on the SSE's Science and Technology Innovation Board, or STAR Market, in 2019, and then on the SZSE ChiNext market and the BSE, finally launching across the China A-share market in 2023.

¹⁶ Chinese regulators have been able to control the pace of IPOs based on market conditions. For example, from August to December 2023, the CSRC tightened the pace of IPO listings as a countercyclical regulatory measure (China Daily 2023).

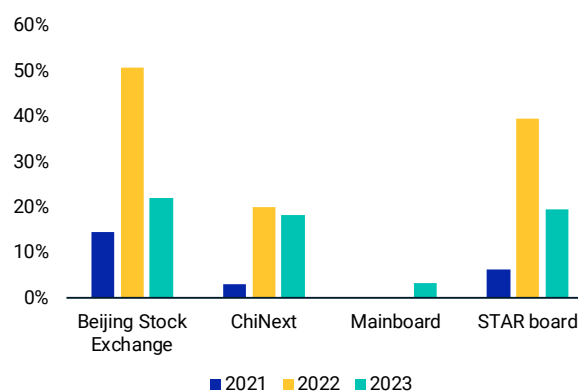
¹⁷ For example, the latest guidelines on strengthening regulation, forestalling risks and promoting the high-quality development of the capital markets, released by China's State Council on April 12, 2024, provided an overarching framework that highlights areas such as IPO regulations, ongoing supervision of listed companies and delisting regulations (China State Council 2024).

Exhibit 15: IPO performance on debut day

Panel A: Average return on IPO days



Panel B: Percentage of IPOs (by number) with negative return on debut days



Data period for panel A is from January 2014 through December 2023, and for panel B from January 2021 through December 2023. Data shown in panel B is constrained by data availability. Source: Wind, MSCI

Connecting the macro and micro: Ecosystem drivers

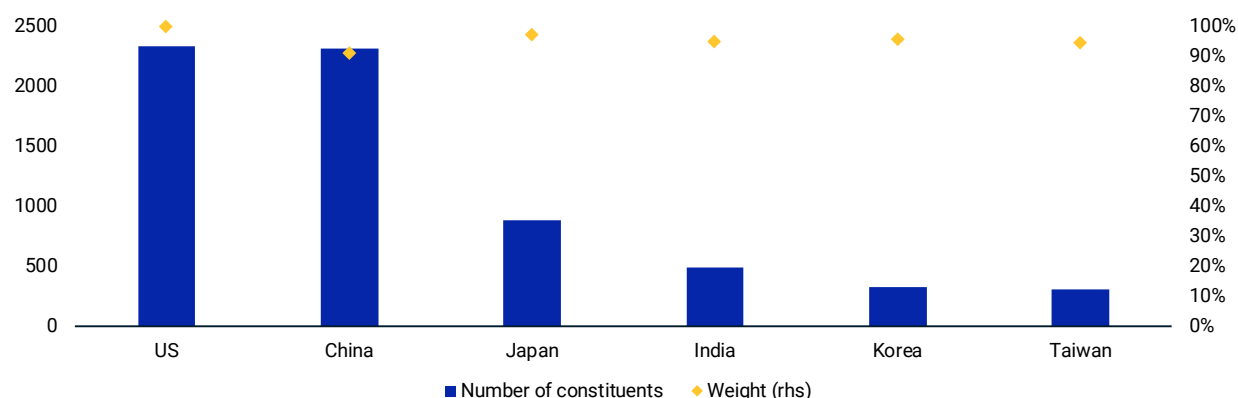
In addition to the macro and micro considerations, other forces play an important role in how the China equity market functions. These include market participants such as sell-side research houses, third-party research institutions and professional service companies, including investment banks, accounting firms, law firms and public relations companies. Additionally, financial products are constantly evolving to address investors' needs, and policy changes — including those related to the economy, particular industries and capital markets — can influence how excess returns are generated and sustained. We refer to these as the ecosystem drivers that weave together the top-down and bottom-up factors to form an integrated and distinctive Chinese capital market.

Extensive sell-side research coverage

Over 4,700 licensed sell-side research analysts operated in China at the end of February 2024, according to data from the Securities Association of China. Consistent with a large sell-side research community, Chinese companies also had extensive analyst coverage. Based on data as of Nov. 30, 2023, from the Institutional Brokers' Estimate System (I/B/E/S), over 2,300 constituents of MSCI China All Shares IMI were covered by sell-side analysts, close to the covered number of constituents of the MSCI USA IMI.

Sell-side coverage, available primarily to institutional investors, could create value by improving investor recognition of the covered companies, according to Li et al. (2015). In addition, extensive coverage of popular names could also help reduce information asymmetry and facilitate closer monitoring of changes in companies' fundamentals. The extensive coverage provided to the institutional segment of the market could partially explain why top institutional-investor-owned stocks could have more-positive analyst sentiment, on average, than the top individual-investor-owned stocks.

Exhibit 16: Sell-side coverage by market



Sell-side coverage data based on number of FY2024 earnings-per-share estimates for each company as of Nov. 30, 2023. Markets are represented by the MSCI USA, MSCI China All Shares, MSCI Japan, MSCI India, MSCI Korea and MSCI Taiwan Investable Market Indexes. Source: I/B/E/S, MSCI

Regulatory intervention as a market anomaly

Regulators are a special type of ecosystem participant. In addition to regulations designed to uphold market integrity and protect investors, the Chinese government has also stepped up to directly inject liquidity during market crises. Cheng et al. (2022) demonstrated that government stock purchases in 2015 lowered the crash risk of the purchased stocks, although such intervention could lead to increased price synchronicity and transaction costs.

In the past, Chinese regulatory bodies have supported the stock market using both indirect and direct approaches. Indirect intervention has included actions commonly seen in other markets, such as looser monetary policy. Direct regulatory intervention has taken several forms over the last decade, including:

- **Window guidance.** Regulators have informally instructed some mutual fund managers to avoid the net selling of stocks (Reuters 2024).
- **Tighter rules on securities lending and share disposal** by major shareholders (Global Times 2023).
- **IPO-related restrictions.** In the past, regulators have controlled the pace of IPOs or frozen them, as in 2013, as a means to implement stricter IPO scrutiny and enhance investor protections (Sydney Morning Herald 2014).
- **Direct stock purchases.** Past examples include the purchase of a broad range of A shares by China's so-called national team¹⁸ during the equity-market turmoil in 2015 and, in October 2023,

¹⁸ The China Securities Finance Corporation Limited (CSF), Central Huijin, CSF customized asset-management plans, CSF customized funds and affiliates of the State Administration of Foreign Exchange are referred to, in aggregate, as the "national team." At the end of 2015, the national team held over 1,500 A-share stocks, with a market value of approximately CNY 3.1 trillion, according to data from Wind.

when Central Huijin¹⁹ increased its holdings of the big-four banks (Bank of China, China Construction Bank, Industrial and Commercial Bank of China and Agriculture Bank of China).

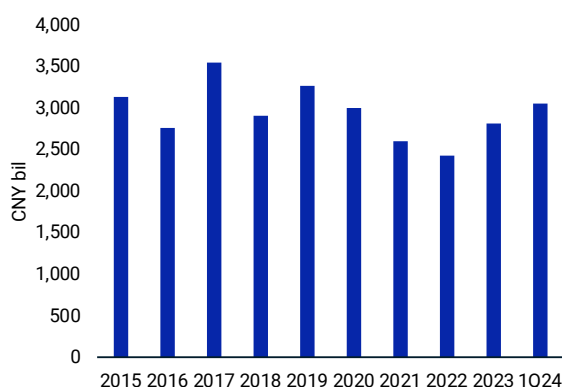
- **Direct ETF purchases.** For example, from October 2023, Central Huijin purchased ETFs in an effort to stabilize the market (Lanxu 2023).

Regulators' direct stock purchases have global precedent. For example, the Bank of Japan and the government of Hong Kong have bought stocks to bolster their equity markets during periods of stress.

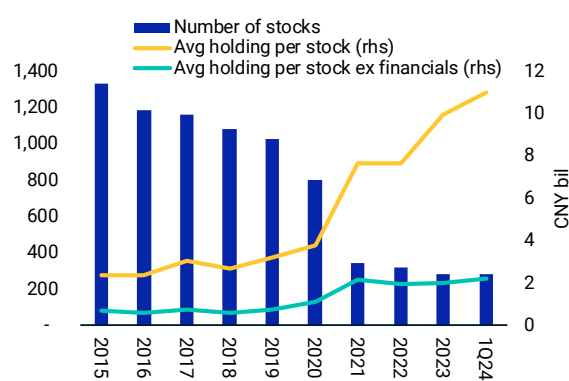
The primary purpose of the national team is to maintain stability in the equity market during a crisis. In addition, Central Huijin acts as a major shareholder of major financial SOEs. Consequently, a significant proportion of the national team's portfolio is in the financials sector.

Exhibit 17: Market value and number of stocks held by China's national team

Panel A: Market value of holdings



Panel B: Number of stocks



Data period is from December 2015 through March 2024. The China Securities Finance Corporation Limited (CSF), Central Huijin, CSF customized asset-management plans, CSF customized funds and affiliates of the State Administration of Foreign Exchange are referred to, in aggregate, as the national team. Source: Wind, MSCI

Acting as a contrarian investor, the national team trimmed its positions in a large number of stocks, primarily small holdings in nonfinancial sectors, when the market was peaking in 2021. As a result, the average position size in the remaining stocks held by the national team rose sharply after 2020, while the market value of holdings has fluctuated, driven by changes to both share price and numbers of shares held.

Expanding ecosystem of financial products

In addition to a comprehensive network of service providers, both financial and nonfinancial, and a well-established and implemented regulatory framework, a diversified portfolio of financial products is essential to a well-functioning market ecosystem. All three elements are needed to adequately support the multiple investment and trading strategies of a broad spectrum of investors, managing mandates with both short-term and long-term investment horizons.

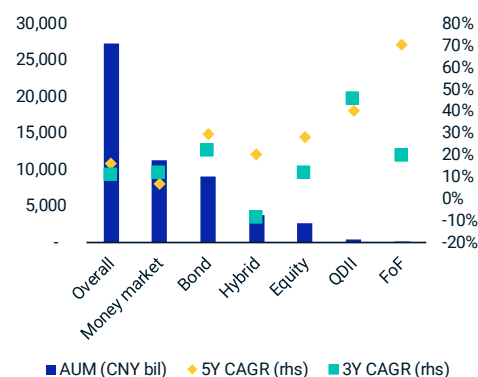
¹⁹ Central Huijin Investment Ltd. (Central Huijin) is a wholly state-owned company in China and a wholly owned subsidiary of China Investment Company. Central Huijin makes equity investments in state-owned major financial enterprises on behalf of the State.

As of year-end 2023, in addition to mutual funds, the financial instruments available in the mainland market included: 1) exchange-traded products (e.g., market-cap, thematic and industry ETFs, REITs and cross-listed products); 2) derivative products (e.g., ETF options, index futures and treasury bond futures); 3) structured products and 4) wealth-management products. The gradual increase in offerings has occurred as financial institutions have responded to the market demand for more-diversified investment strategies.

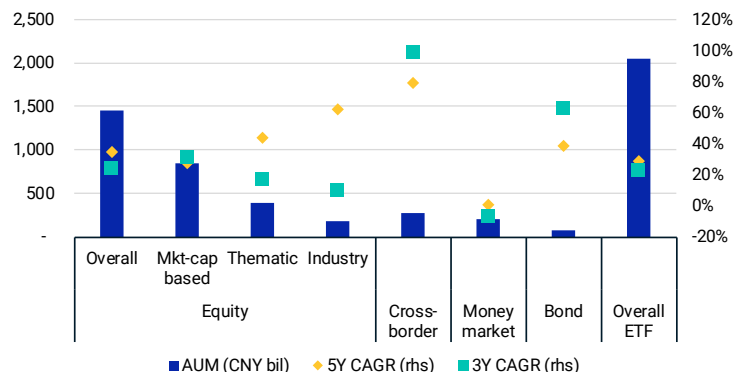
Mutual funds in the mainland market had AUM of CNY 27.3 trillion (USD 3.8 trillion) at year-end 2023. They grew at a 16% compounded annual growth rate (CAGR) from 2019 to 2023, driven primarily by bond, hybrid and equity mutual funds. Over the same period, AUM of ETFs expanded by a 29% CAGR and totaled CNY 2.1 trillion (USD 289 billion) at year-end 2023. The three-year growth rate of market-cap-based equity ETFs, cross-border ETFs and bond ETFs was higher than over the last five years.

Exhibit 22: AUM in mainland mutual funds and ETFs

Panel A: Mutual funds



Panel B: ETFs



Data as of Dec. 29, 2023. Source: Wind, MSCI

The range of financial product offerings is more comprehensive in the Hong Kong market than in the mainland market. The continued addition of new instruments, such as certain indexed derivatives, leveraged and inverse ETFs, and interest-rate products, has allowed for further expansion of global investors' ability to better hedge portfolio risk and develop cross-border strategies.

New and innovative products in the China market have been developed and implemented with the support of regulatory bodies, designed to meet the needs and demands of an increasingly diversified investor community. The investing behavior and demographics of Chinese households could lead to 1) increased indirect participation in the stock market, such as through mutual funds, 2) demand for more-sophisticated investment-advisory services and 3) a larger number of long-term investors, especially in the A-share market, which may influence future product development and market dynamics.

Conclusion: Applying a framework to assess excess return

After decades of rapid economic expansion, China's economic policy has shifted from the pursuit of a high growth rate to encouraging high-quality development, with an intensive emphasis on innovation. Other considerations, including the evolving geopolitical landscape, prevailing global investment themes and China's adapting market mechanisms, have made investing in Chinese equities becoming potentially more complex. A pure macro-based asset-allocation perspective, focusing predominantly on market beta, may not fully capture the scope and diversification potential of a dedicated China allocation.

During periods of market turbulence and macroeconomic uncertainty, an equally, if not more, significant contributor to a competitive total return may be the excess return earned above a portfolio's benchmark. Our analysis showed that against the backdrop of the challenging market environment from 2021 to 2023, some dedicated China funds were able to deliver significant excess returns (largely from factor exposures and asset-specific returns). The lesson here appears to be that a thorough understanding of the drivers of excess returns in the China market could be an important input in investors' decision making for those considering a dedicated allocation or total portfolio approach to investing in the China equity market.

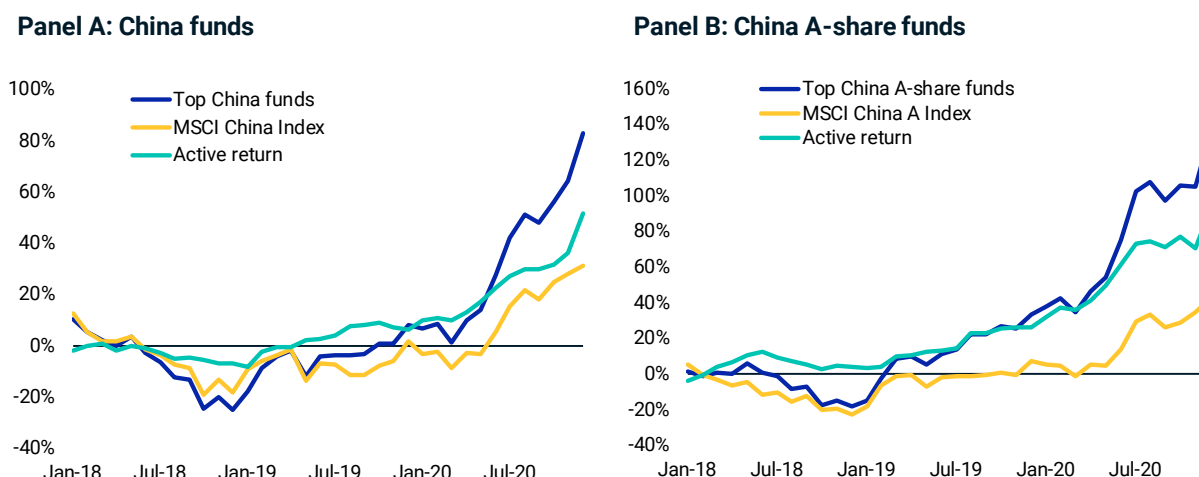
The three-layer framework we propose in this paper – top-down market drivers, bottom-up market drivers and ecosystem components – could help investors better understand the potential drivers of excess returns accessible through a dedicated China investment strategy. Combining an understanding of the key drivers of market beta, as outlined by Wei, Xu and Xu (2021c), and the separate drivers of potential excess returns, as outlined in this paper, may be a useful guide to asset allocators and investors in shaping a dedicated China strategy and allocation.

Appendix A. Performance review of a dedicated China fund, 2018-2020

We analyzed the performance of the top-performing dedicated China funds for the three-year period from 2018 through 2020 for comparison purposes. The top five China funds and top 10% of China A-share funds in our sample universe²⁰ achieved double-digit annualized excess returns compared to the MSCI China and MSCI China A Indexes, respectively.

We found that the characteristics of the top-performing China-dedicated mutual funds over the period 2018-2020 had distinctly different performance attributions and style-factor exposures compared to the top performers from 2021 through 2023. The differences could reflect the considerably different market environments that characterized the two periods.

Exhibit A1: Cumulative performance of top-performing dedicated China funds, 2018-2020



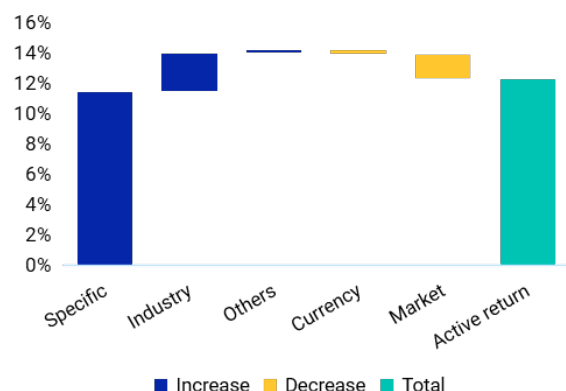
Data period is from January 2018 to December 2020. The top China funds include the top five performers of dedicated China funds in the Hong Kong market, and the top China A-share funds include the top 10% of best performers of China-mainland mutual funds. Source: Wind, MSCI

The top China funds' excess return over this period was primarily attributable to asset-specific returns, and to a lesser degree to the industry factor. Style's contribution, although positive, was minimal. These funds were more actively exposed to size, momentum and growth factors and less actively exposed to the book-to-price factor in the A-share market.

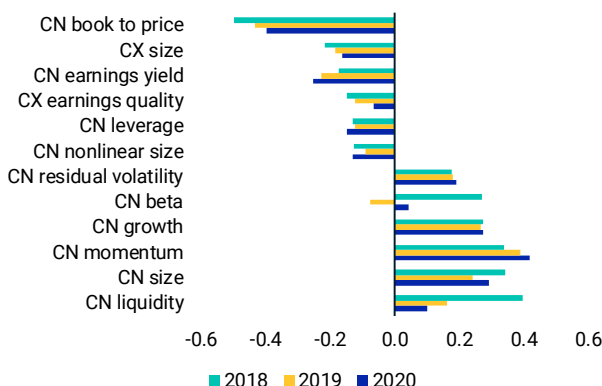
²⁰ The China fund universe includes 78 funds, and the China A-share fund universe includes about 1,800 funds.

Exhibit A2: Performance attribution and style exposures of top-performing China funds, 2018-2020

Panel A: Performance attribution



Panel B: Active style exposure

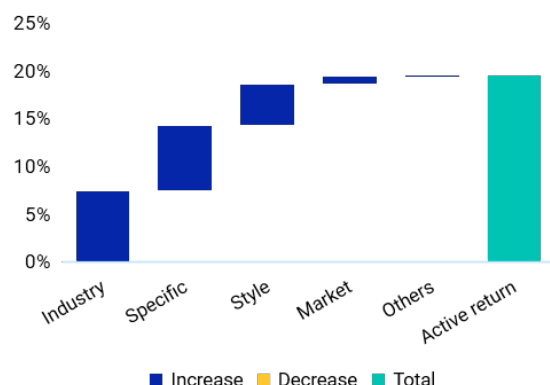


Data period is from January 2018 to December 2020. Based on output from the MSCI MAC.L model. Base currency is USD. MSCI China Index is the benchmark. Source: Wind, MSCI Global Research.

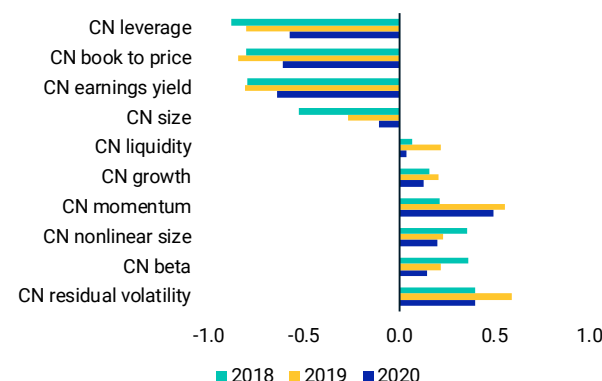
The excess-return attribution for the top China A-share funds showed meaningful positive contributions from the industry and style factors and asset-specific returns. Compared to the MSCI China A Index, the top China A-share funds had higher active exposures to volatility, such as residual volatility and beta, as well as to the midcap²¹ and momentum factors. The funds had lower active exposures to the leverage, book-to-price and earnings-yield factors.

Exhibit A3: Performance attribution and style exposures of top-performing China A-share funds, 2018-2020

Panel A: Performance attribution



Panel B: Active style exposure



Data period is from January 2018 to December 2020. Based on output from the MSCI MAC.L model. Base currency is CNY. The MSCI China A Index is the benchmark. Source: Wind, MSCI Global Research.

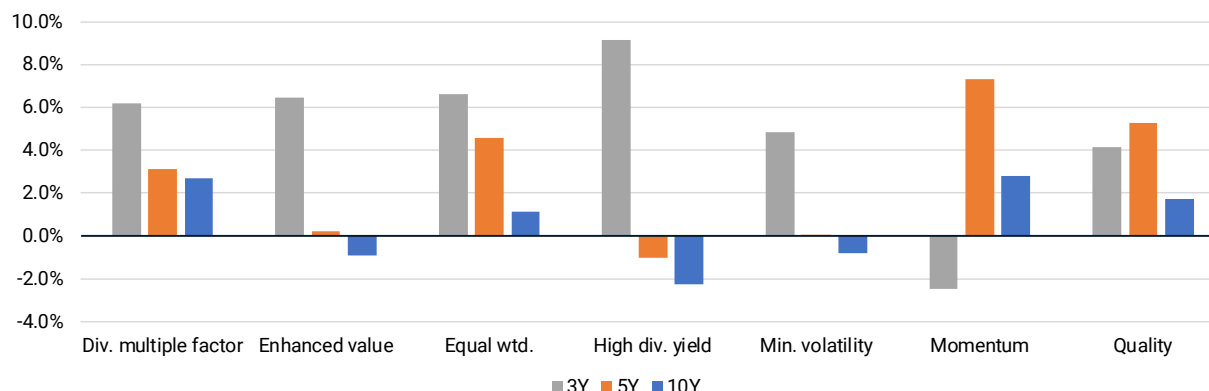
²¹ The midcap factor [aims to capture risk and return characteristics of stocks toward the middle range of the market-capitalization spectrum](#), net of other systematic factors.

Appendix B. Factor risk premium in China equity markets

Performance of single style factors in the short term may not be persistent in the long term.²² Due to swift market swings and quick shifts in investors' focus, single factors have shown strong cyclicalality, particularly in the A-share market. The rapid changes in focus could also partially explain the challenges faced by some investors in delivering persistent outperformance.

Nonetheless, MSCI's diversified multiple factor, which captures the value, low-size, momentum and quality factors, has consistently delivered excess returns in the broad China market, represented by the MSCI China Index, in the 3-, 5- and 10-year periods ending December 2023. The factor earned an annualized 6.2% excess return for the period 2021-2023. The factor also posted excess returns in the 3- and 10-year periods ending December 2023 in the China A-share market, represented by the MSCI China A Index. The factor's annualized excess return for the period 2021-2023 was 2.2%.

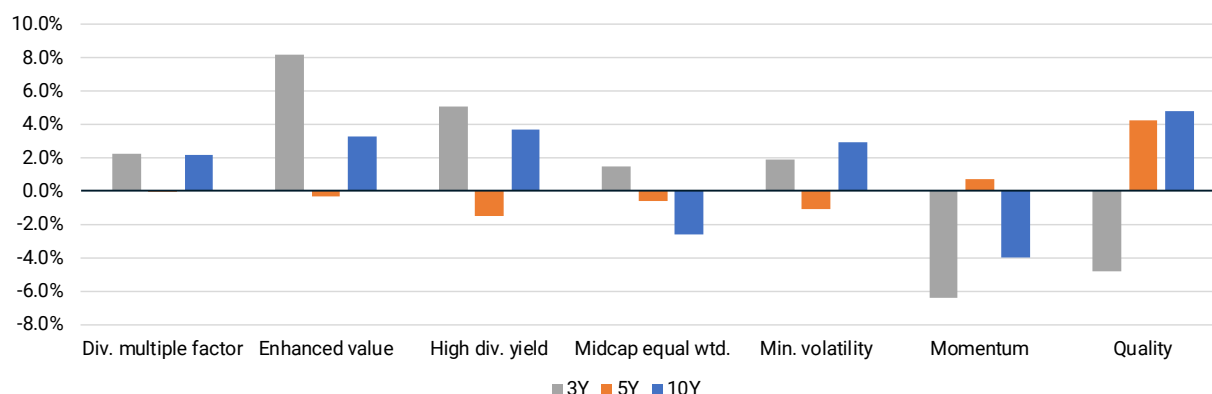
Exhibit B1: Annualized excess return of factor indexes, MSCI China Index



Data period is from January 2014 through December 2023. Annualized gross return is in local currency. The low-size factor is represented by MSCI China Equal Weighted Index.

²² Factor behavior in the China market, compared to the developed markets, could differ due to its unique features. For example, in the U.S. equity market, low volatility could be biased toward large-cap stocks, but as HSBC (2024) showed, the low-volatility factor has been indifferent to the size effect in the China A-share market.

Exhibit B2: Annualized excess return of factor indexes, MSCI China A Index



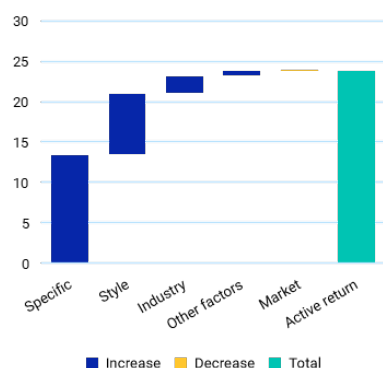
Data period is from January 2014 through December 2023. Annualized gross return is in local currency. The small-size factor is represented by MSCI China A Mid Cap Equal Weighted Index.

Appendix C. Examples of top-performing dedicated China funds

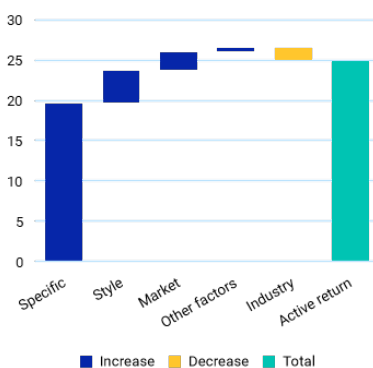
We conducted a performance attribution analysis of three top-performing China A-shares mutual funds over three-year periods, ending December 2023. These funds earned a 14%, 16% and 10% absolute annualized return over the three-year period with most of the excess return attributable to asset-specific return, with style also contributing notably for two of the funds.

Exhibit C1: Performance attribution of three top performers, 2021-2023

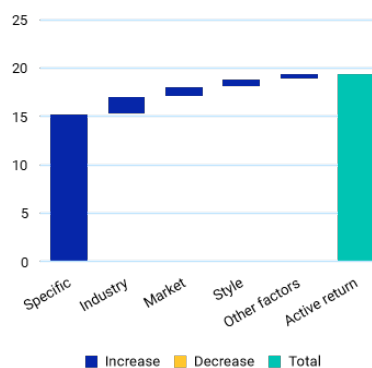
Panel A: 14% annualized return



Panel B: 16% annualized return



Panel C: 10% annualized return



Data period is from Dec. 31, 2020, to Dec. 29, 2023. Based on the MAC.L model, using the MSCI China A Index as the benchmark and CNY as the base currency. The three examples are drawn from our sample universe of China A-share funds. They were selected as examples of sustained outperformers during the studied period which included both bull market and bear market cycles, because they had the highest average AUM of the top 10 performers, based on adjusted NAV per share, over the 2018-2023 period and were included in the top 50 performers over the 2021-2023. Source: Wind, MSCI

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