NIPUN CAPITAL, L.P.

China A: Bigger Than Expected

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In our previous white paper entitled, "China A: Right Here, Right Now," we highlighted the return potential in Chinese domestic equities and suggested that investors should build exposure to Chinese A shares sooner rather than later. In this paper, we argue that investors are hugely underestimating the potential size and importance of China in the MSCI global indices. Further, we provide a framework that investors can use to determine the optimal allocation to Chinese A shares, within an Emerging Market portfolio. We conclude that China is rapidly emerging as a ***distinct asset class*** with unique characteristics and that a China allocation is best implemented through a China specialist manager.

Our summary observations are:

- MSCI is in the process of adding Chinese A shares to the MSCI Emerging Markets Index (EM) at 5% inclusion factor in 2018. MSCI projects that at full 100% inclusion, Chinese A shares would represent 17% of the Index.
- We believe that the 17% weighting is significantly underestimated and that Chinese A shares could represent as much as 28% of MSCI EM and all China could represent 8.5% of MSCI All Country World Index (ACWI) over the next few years.
- In light of this, institutional investors need to revisit their policy allocations to Emerging Markets and China, and determine how to best implement this allocation.
- Using a set of simple assumptions, we demonstrate that an optimal allocation to Chinese A shares within an Emerging Markets portfolio currently is between 20-30%.
- Broad based Emerging Market managers most likely lack the China specific insights required to be successful in this market. We believe that the best way to implement this China allocation is through a China specialist manager.

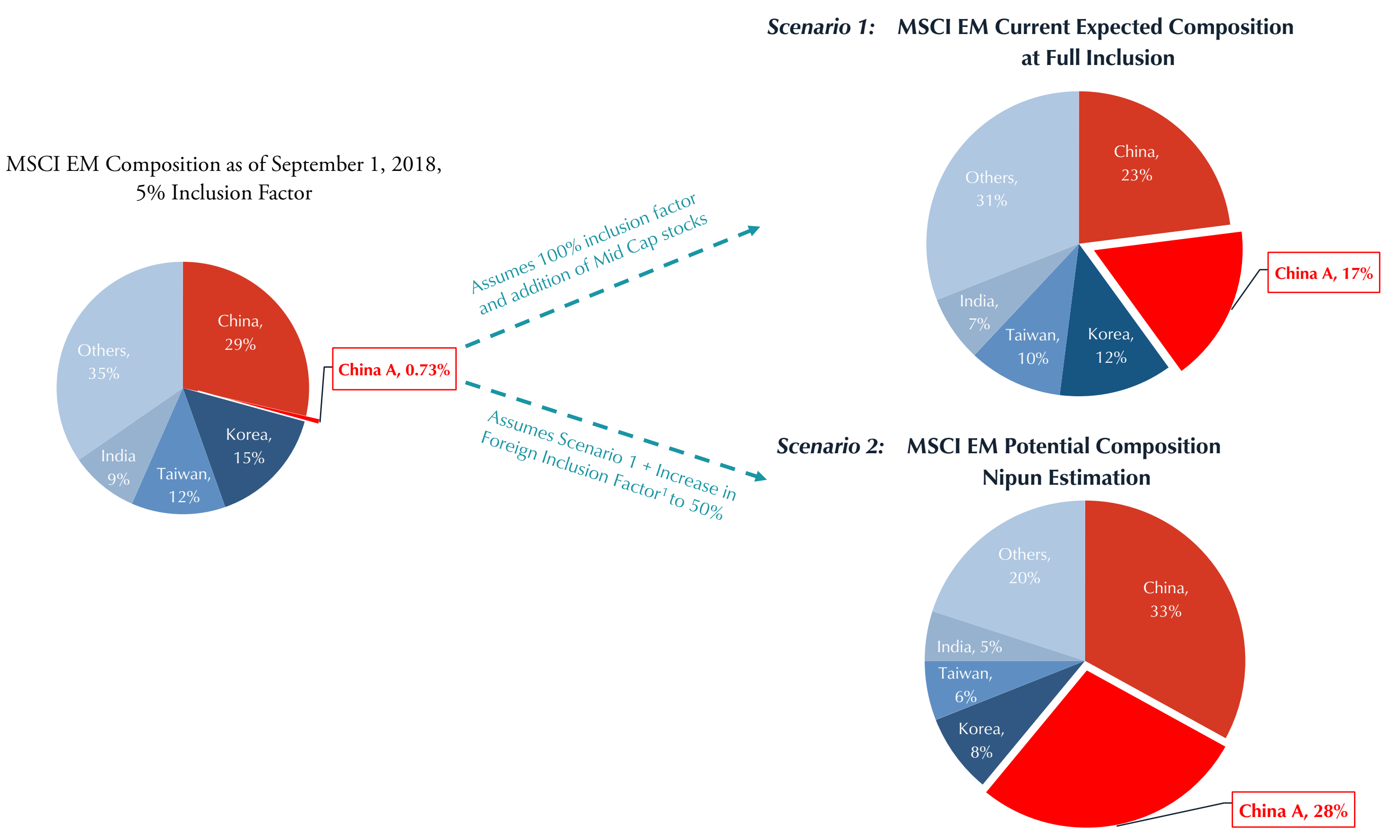
China's importance in world benchmarks is likely to be higher than expected

"Emerging Markets may never be the same," read a recent email from MSCI. Dramatic as this may sound, investors are still under estimating the impact of Chinese A shares on their portfolios, their EM allocations and on global indices like the MSCI ACWI.

By September 1, 2018, Chinese A shares are likely to be 0.73% of the MSCI EM Index, representing a 5% inclusion factor i.e. only 5% of the total eligible market cap of the selected 234 stocks is being included at this time. If the inclusion factor were increased to 100%, Chinese A shares would represent 17% of the MSCI EM Index. The pace and extent of this inclusion is dependent on a few different factors but the 17% has become a much bandied around number.

We believe that the 17% weighing is significantly underestimated. A detailed review of how MSCI constructs the indices leads us to a scenario where we project Chinese A shares to comprise 28% of MSCI EM. Combining this with Chinese overseas listings (Hong Kong and U.S. listed Chinese stocks) result in a scenario where Chinese companies as a whole represent 61% of the MSCI EM Index.

Chinese A Shares could represent 28% of MSCI EM Index over the next few years



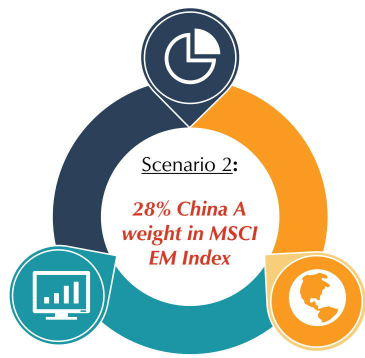
Source: MSCI, Nipun Internal Analysis.
[1]The weight of each security in the MSCI indices is determined by the security's free float–adjusted market capitalization, adjusted using the Foreign Inclusion factor (FIF), subject to the Foreign Ownership Limit (FOL). Currently, the FOL across all Chinese A stocks in 0.3.
All charts provided herein are for informational purposes only and should not be relied upon when making any investment decision.

For Scenario 2 to become a reality, the following three events would need to occur:

Anticipated China A roadmap to full representation in MSCI EM Index

Addition of China A Mid Cap Names

- Current inclusion is restricted to Large Cap stocks
- MSCI EM Index is intended to represent both Large Cap and Mid Cap stocks
- All other EM markets include Mid Cap stocks



Increase in China's Inclusion Factor from 5% to 100%

- MSCI has provided clear guidance for inclusion[1]
- Accessibility to China's domestic equity market continues to improve
- Chinese authorities addressing issues one by one and have a stated goal of increasing foreign ownership of their equity market from 2% to 10%

Increase in Foreign Inclusion Factor (FIF) from 30% to 50%

- Chinese authorities in process of allowing free float to increase; developing mechanism to unlock currently restricted shares
- China is increasing foreign ownership limits
- Average FIF for Korean and Taiwan stocks are currently 60% and 70%

[1] See Appendix 1 for further inclusion guidelines

This has two very significant implications:

- Firstly, we believe that at this more representative size, China becomes its own asset class with a broad MSCI China Index. It is large, liquid and distinct. MSCI is likely to launch an Emerging Markets ex-China Index, which becomes widely accepted but significantly smaller in importance than today's broad EM Index.

- Secondly, China's weighting in ACWI grows from almost 4% in 2018 to 8.5% in the future. This implies that China becomes the second largest market in ACWI, behind the U.S. but ahead of Japan. We encourage investors to ponder on this scenario for a moment: "China is your second largest public equity exposure."

Expected Composition of MSCI ACWI (%)

	Sep 1, 2018	Scenario 1	Scenario 2
US	52.0	51.0	49.4
Japan	8.0	7.8	7.6
China	3.7	5.6	8.5

Source: Nipun Internal Analysis

How much should you allocate to China A shares today?

Regardless of inclusion assumptions, MSCI's decision to add China A shares to its indices will require investors to revisit their EM allocation. China A shares offer a significant investment opportunity, while also providing diversification benefits. The size of a China A allocation in an EM portfolio will depend on several factors, including:

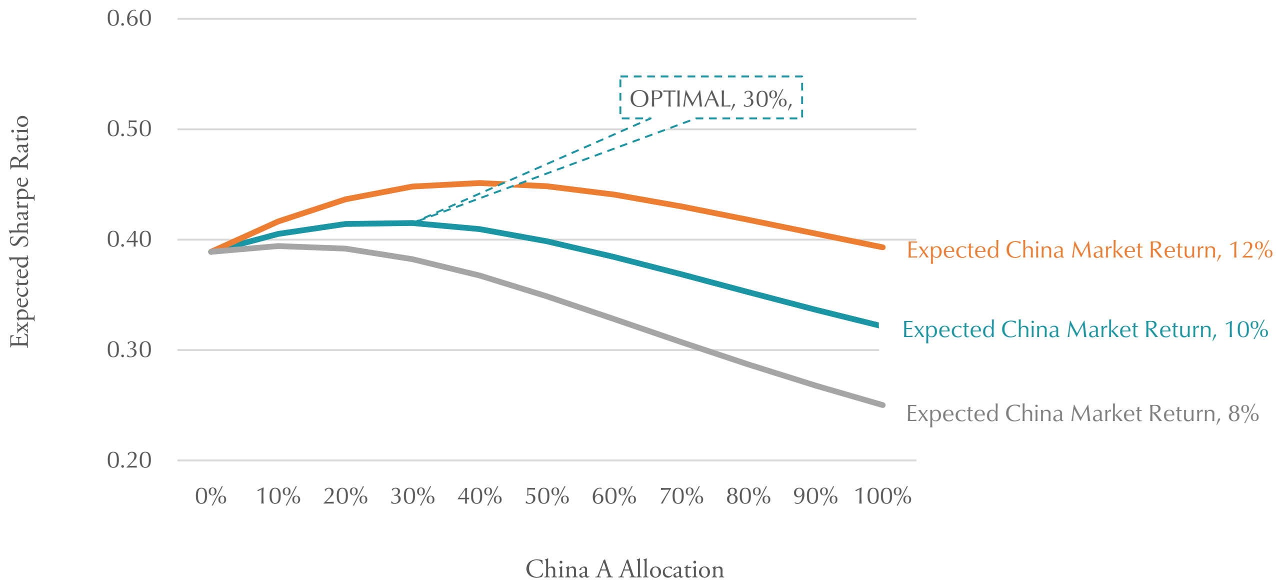
- Return and volatility assumptions for China and EM, as well as correlation of returns
- Expectations of alpha and tracking error for China and EM active managers
- Tolerance for tracking error

Using a simple framework to demonstrate the benefit of adding a China A allocation to an EM portfolio, along with the below assumptions, we find that an optimal China A allocation is between 20-30% of an EM allocation.

Optimal China A allocation relative to EM is 30%

Optimal China A Allocation Relative to EM

Assuming MSCI EM Expected Volatility 18% and China A 28%
Expected Correlation Between EM and China A 50%[1]
Expected EM Market Return 8%



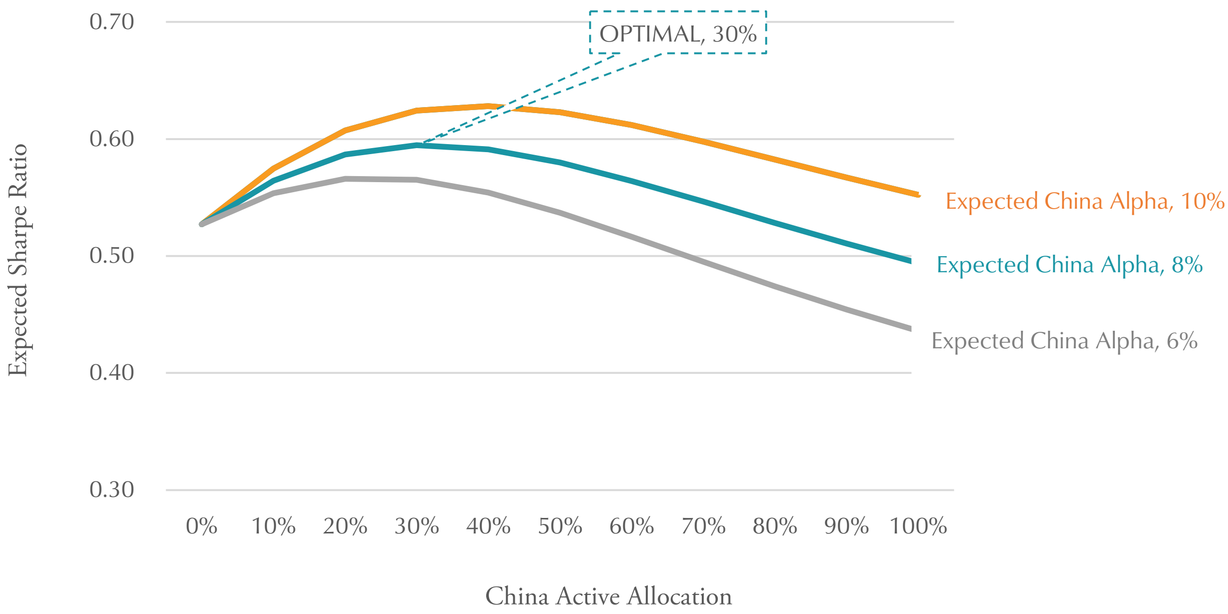
Source: Nipun Internal Analysis. [1]The realized volatility for the Shanghai Composite Index from 1996-2017 is 27.8%. The realized correlation in returns between MSCI China A International Index and MSCI EM Index from February 2010-January 2018 is 50%.

The previous analysis was based on market wide expected returns, or beta returns alone. Moving a step further, we can also evaluate the benefits of active management in China. As we outlined in our earlier paper, "China A: Right Here, Right Now," China today is one of the richest alpha potential sources in global equity markets. Again, we make simplifying assumptions and find that an active China allocation of 20-40% in EM is optimal especially given that skilled active China A managers may be able to achieve much higher alpha versus EM managers. This allocation appears to maximize both Sharpe ratio and Information Ratio.

Optimal China Active allocation could be 20-40%

Optimal China Active Allocation

Assuming Active EM Portfolio Tracking Error at 6%, Active China A at 20%
Expected Correlation between Active Managers in EM and China A 50%
Expected Active EM Alpha 3%



Source: Nipun Internal Analysis

Using a set of simple assumptions results in a significant allocation to China A shares in an EM portfolio. Please let us know if you would like further details on our allocation framework. By simply adding the second largest equity market in the world to global indices, MSCI has enabled EM allocators to potentially transform their allocations significantly for the better.

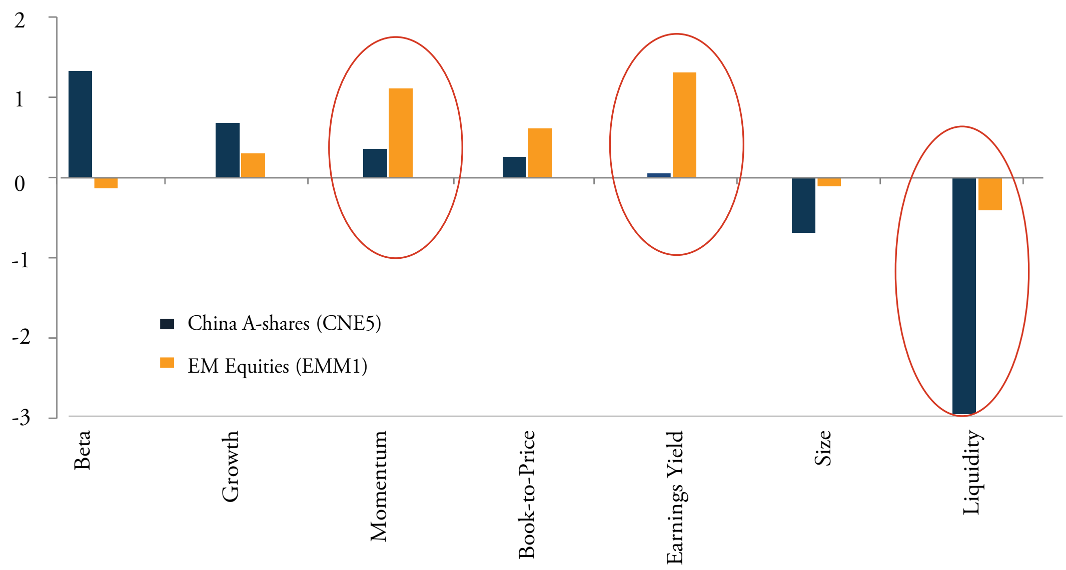
Investing successfully in China A requires specialized expertise

Keeping in mind the potential size of the Chinese market and the risk/reward trade-off, institutions need to decide how much to allocate to this market. Next, they need to decide how to obtain this exposure – through a passive or active mandate. We strongly believe that an active approach has significant merits in China. We discussed the opportunity for active management in our previous paper, published in April, entitled, ‘China A: Right Here, Right Now’.

To implement an active approach in China, investors could choose to rely on their Global Emerging Markets’ managers or decide to go with a specialist China manager. We believe there is no prescriptive answer here. Ultimately, active managers need to have a sustainable competitive edge to succeed. China is a distinct market with many subtle intricacies and we believe a generic approach to investing in other emerging markets is unlikely to succeed in China. Active managers effectively need to become China experts given that nearly one out of every two investment opportunities available to EM investors will be a Chinese company.

China has historically been neither a Value nor Momentum market… but why?

Historical Information Ratios of Barra Risk & Style Factors



Source: MSCI Research Insights, June 2017. Based on Barra factor performance from January 2006 to October 2016.

Nipun brings depth and nuance to analyzing China's distinct equity market

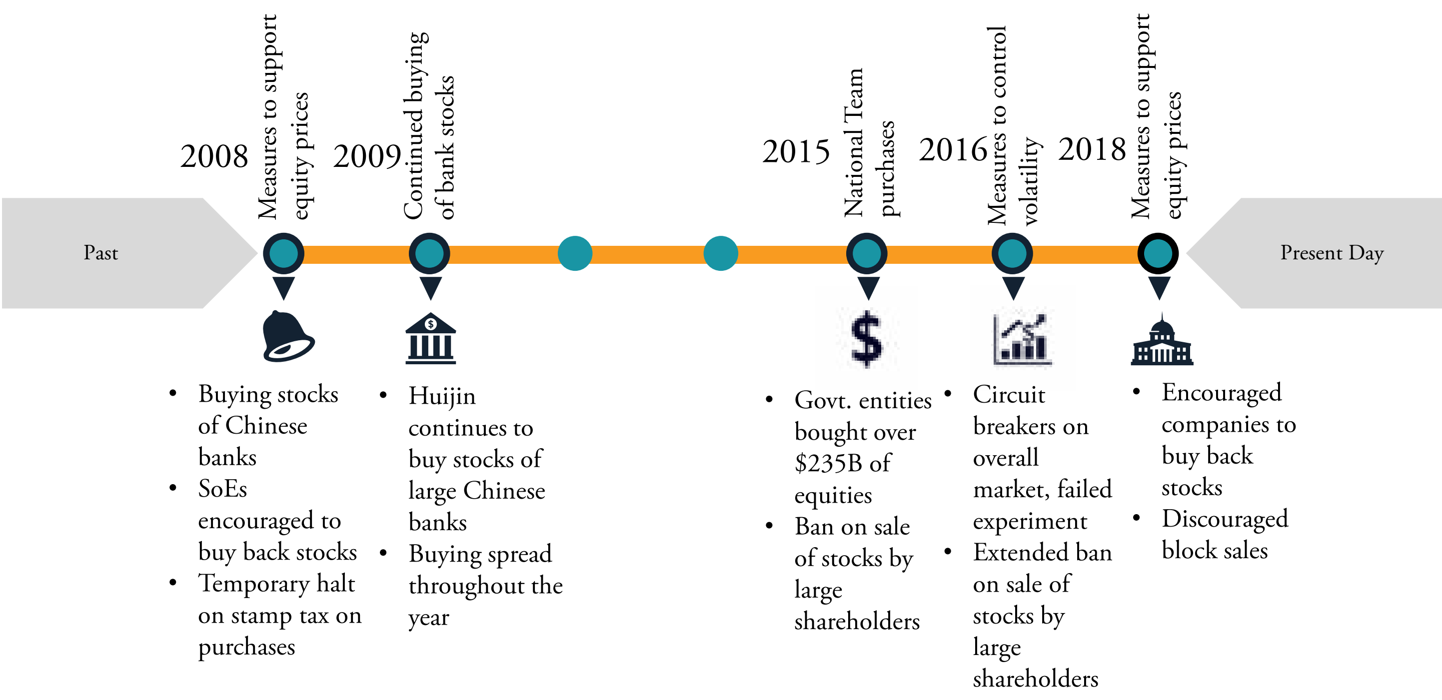
China has a unique model of "capitalism without yielding control." As the Financial Times recently put it, "The Chinese have developed a state system run by a technocratic elite of highly educated bureaucrats under party control." Their model is not well understood by the western world. There is no clear distinction between the state and the judiciary, and corporations are often run by bureaucrats appointed by the state as opposed to economically incentivized professional executives. Nevertheless, this system has delivered extremely strong economic results.

Many of these differences have implications for the capital markets but requires focused expertise to extract the nuances. We have formed numerous ideas that are distinct to Chinese equities. We highlight three:

1) Role of the State

The Chinese government, through its various entities, has historically intervened, either indirectly or directly, in its equity markets. Intervention has taken the form of controlling the IPO process, providing subsidies to corporations, and direct purchases of equities through its "National Team" to support the market amongst others. Past interventions have primarily been aimed at reducing volatility in the market. Understanding the incentives and forms of government interventions will likely be required to successfully invest in China.

History – Role of Government (Some Examples)

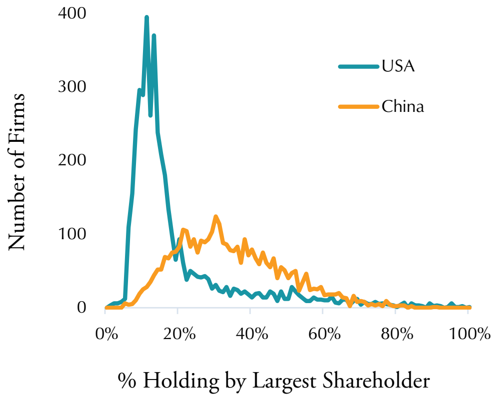


Source: Bloomberg, Raymond Hélène, "Sovereign Wealth Funds as domestic investors of last resort during crises", Economie internationale, March 2010, Reuters

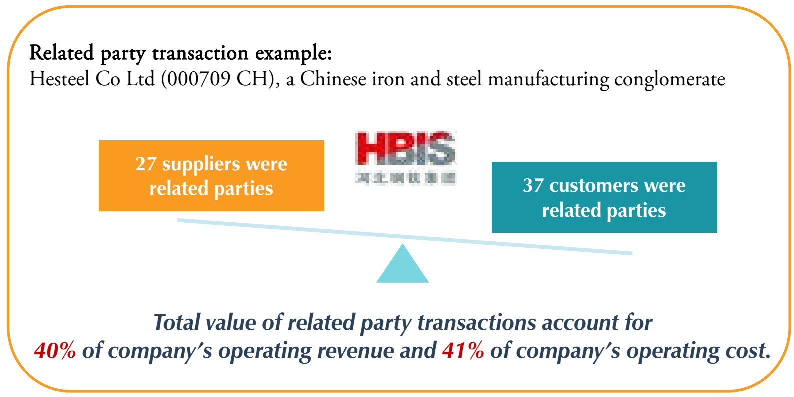
2) Block Ownership

All Chinese listed firms have a controlling shareholder, typically with 20% or more in percentage ownership. The controlling shareholder is often not well aligned with minority shareholders. Investor protection laws are poor and enforcement is weak. As a result, block holders can cause the company to engage in transactions that benefit them, at the expense of the minority shareholder. Examples of these transactions include loans to block holders, asset swaps, and financing transactions with related entities.

Ownership of Largest Shareholder



Source: Wind information

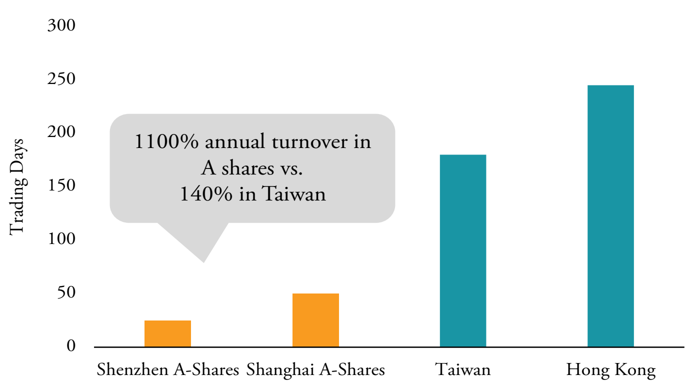


Source: Fully disclosed in 2015 Annual Financials.

3) Retail Participation

Chinese investors trade a lot, even compared to other retail dominated Asian markets. Part of this maybe driven by cultural differences. There is a saying in China that the domestic equity market is a better gambling venue than Macau. The behavior of these high turnover investors results in an equity market exhibiting unique characteristics.

Chinese investors have extremely short holding periods



Source: Nipun Internal Analysis. Based on data from 2015.

Propensity to trade:

- 85% of trades are retail
- Retail investors' average holding period is 25 days
- Retail investors herd and invest without a focus on company fundamentals

Although the Chinese equity market is relatively inefficient, success in China will require a detailed understanding of the unique factors that impact stock prices there. The above factors range from the macro (government intervention) to the micro (intra-day retail trading behavior) and are just three examples of the many distinct drivers that investors must take into account when investing in China. A nuanced understanding of these factors and how to incorporate them will be paramount for success. This is especially true when China's unique market dynamics render some well-known predictors of returns (momentum and value) to be largely ineffective.

Conclusion

By adding China to its global indices, MSCI has signaled to the investing community that the second largest equity market in the world is ready for the global stage. The inclusion of China A shares provides foreign investors, who have traditionally been underweight China for legacy reasons, a significant new investment opportunity.

As a result, investors will need to revisit their global EM and China allocations. Although China's initial inclusion is small, we believe China's A share weight is expected to grow quickly and beyond the well cited 17% projected weighting in the MSCI EM Index. We estimate that in the next few years, China A weight could become 28% of the MSCI EM Index and Chinese stocks (A shares and overseas) could become the second largest market in ACWI behind the U.S. and ahead of Japan at 8.5%. Furthermore, we find that an optimal allocation to Chinese A shares within an Emerging Market portfolio currently is between 20-30%.

China is rapidly emerging as a distinct asset class with unique characteristics. Understanding why certain well known global predictors of returns are largely ineffective and the multiple nuanced factors impacting stock prices in China will be paramount to success. Broad based EM managers, with their "one size fits all" method towards stock selection, most likely lack the China specific insights required to be successful in this market. As a result, we believe that a China allocation is best implemented through a China specialist manager.

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APPENDIX 1

MSCI's Roadmap of Future China A Shares Inclusion

MSCI put China A shares on the 2014 Market Classification Review list in 2013 and finally made the announcement to partially include China A shares in the various indices in June 2017. Over that time period, the Chinese authorities took various steps to improve:

- **Accessibility**: The launch of the Stock Connect program in late 2014 and its further expansion in 2016 significantly improved market access for foreign investors, compared to the previous QFII and RQFII regimes. Further steps here would include broadening the numbers of stocks eligible on the Connect, expanding the Connect to include IPOs etc.

- **Investability**: The steps taken by the Chinese authorities to reduce the number and duration of trading suspensions has been viewed favorably by overseas investors. Further steps would include greater alignment of the China A shares market with international markets, e.g. synchronization of market holidays between China and Hong Kong, increase in foreign ownership limits.

- **Scalability**: The dismantling of the Aggregate Quota and the increase in the daily limits tradeable on the Connect have improved the ability of investors to build scale within China A. Institutional investors (and MSCI) are looking to evaluate the resilience of the Stock Connect and further loosening of restrictions on the creation of index linked investment vehicles like futures to allow scale in a cost effective manner.

MSCI has stated that it would continue to 'monitor the situation' on the above criterion and further inclusion would depend on the progress that China makes on these dimensions.

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