ACADIAN

PERSPECTIVES
VIEWPOINTS FROM THE ACADIAN TEAM

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CHINA A-SHARES: OPPORTUNITY IN THE YEAR OF THE PIG

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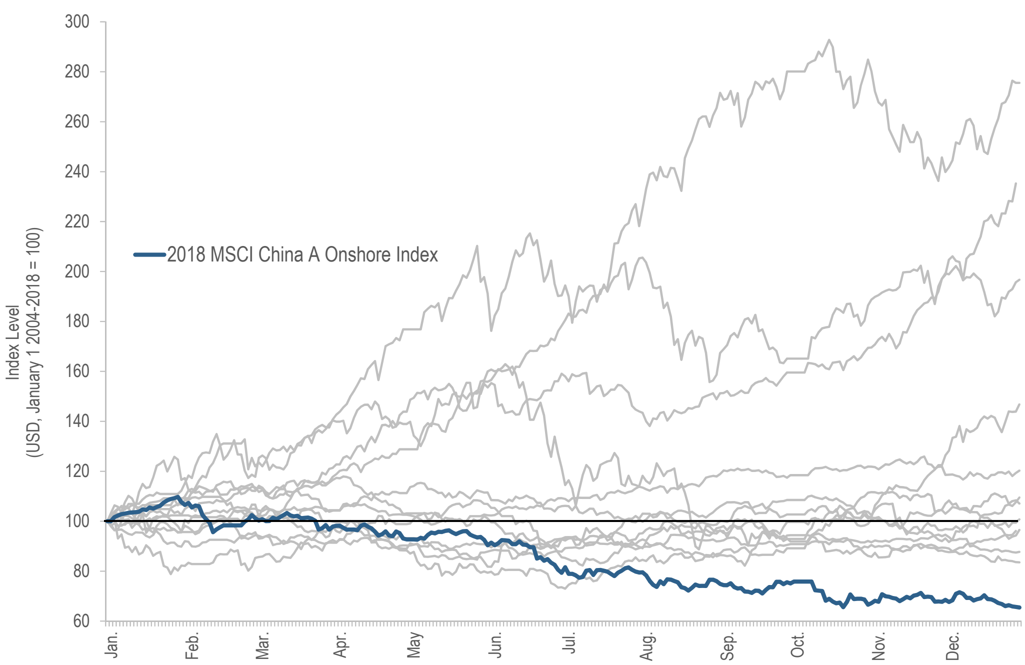
- The A-shares market is continuing to liberalize–a trend likely to intensify in 2019
- A tactical opportunity exists at current valuation levels
- China will play an increasingly important role in strategic asset allocations

The Year of the Dog, 2018, was an extraordinary year for China. It marked the 40th anniversary of the country's transformative economic reforms and witnessed the initial inclusion of China A-shares into commonly used global benchmarks.[1,2] 2018 also saw one of the deepest equity market drawdowns in the country's history. As the Chinese lunisolar calendar turns to the Year of the Pig, we see immediate and longer-term opportunities in China A-shares materializing.

2018 DRAWDOWN: CURRENT OPPORTUNITY?

China A-shares rallied in early 2018, but negative sentiment developed late in the first quarter, and a protracted drawdown ensued. Figure 1 shows that 2018 was the deepest calendar-year drawdown in China A-shares history.

FIGURE 1: CHINA A-SHARES: CALENDAR YEAR PERFORMANCE 2004-2018



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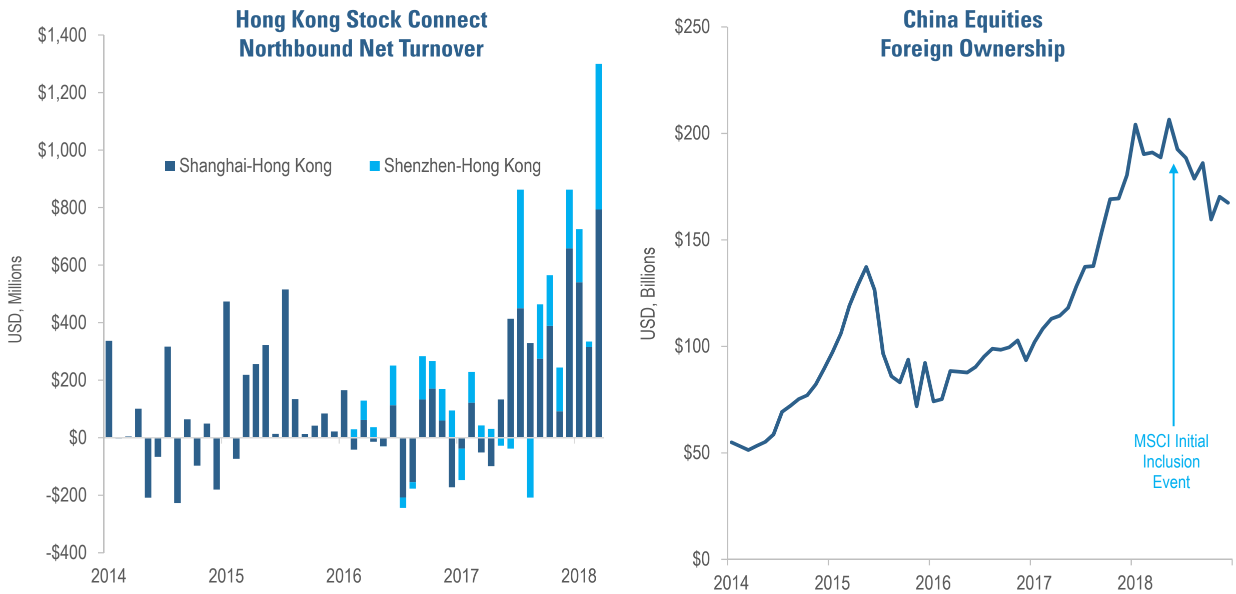
1 China A-shares comprise China's onshore equity market. The terms 'A-shares' and 'onshore' are fungible.

2 For more on this event see Acadian's overview *Welcome to the EM Index.*

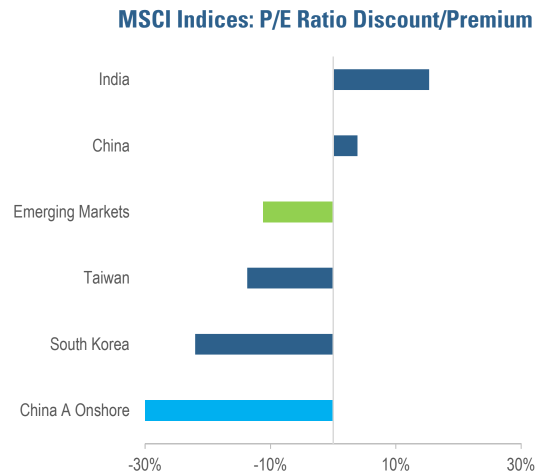
2018 also saw the China A-shares market open further to foreign investors. The Hong Kong Stock Connect program's northbound turnover increased, and MSCI included A-shares in several of its benchmarks. The MSCI event, best characterized as modest in magnitude but monumental in significance, was effectively overshadowed by international trade frictions and bursts of geopolitical tensions that verged on brinkmanship. While global equity investors were not entirely discouraged by these circumstances, as evidenced by an increase in non-Chinese ownership of onshore stocks (figure 2B), they were undoubtedly unsettling and helped to drive multiples to historic lows.

FIGURES 2A & 2B: CHINA ONSHORE, FOREIGN INVESTOR ACTIVITY



As of December 31, 2018. Figure 2A source: Bloomberg. Shanghai and Shenzhen Stock Exchanges. Acadian analysis. Figure 2B source: Bloomberg. PBoC. Acadian analysis. It is not possible to invest directly in any index. Every investment program has an opportunity for loss as well as profit. For illustrative purposes only.

FIGURES 3A & 3B: VALUATIONS



As of January 31, 2019. Figure 3A: Source: MSCI, Bloomberg, Acadian analysis. Figure 3B: Discount to median (trailing 60 months) in local currency. Source: MSCI, Bloomberg, Acadian analysis. In local currency. Copyright MSCI 2019. All Rights Reserved. Unpublished. Proprietary to MSCI. For illustrative purposes only. It is not possible to invest directly in any index. Every investment program has the opportunity for losses as well as profits. Past results are not indicative of future results.

Despite this backdrop, we see positive indicators, including stable profit margins and operating cash flows as well as resilient consumption and exports. Compression of the trailing P/E multiple was therefore not entirely attributable to a contemporaneous erosion of fundamentals. In short, we believe last year's drawdown was an overreaction which unduly and broadly penalized the entire A-shares market and, that current valuation levels, offer an attractive entry point. Figures 3A and 3B underscore this point from both an onshore and country-relative perspective.

CHINA'S INCREASING IMPORTANCE

The increased weight of China onshore companies in widely used investment benchmarks increases China's relevance with respect to strategic asset allocations. In that context, there are two significant events coming in 2019: 1) FTSE will for the first time include A-shares in its emerging markets benchmark, joining MSCI. 2) In addition, MSCI is quadrupling the weight of A-shares in its widely utilized Emerging Markets Index.[3]

MSCI is forecasting that A-shares will eventually comprise approximately 15% of the entire index with China commanding a full 40%.[4] South Korea, which has the second largest weight in the MSCI Emerging Markets index, comprises just 13.9%, followed by Taiwan and India at 10.6% and 8.4%, respectively.[5]

Global investors often divide developed equity markets into U.S. and ex-U.S. categories based on the size, diversity, and vibrance of the U.S. economy. We believe the same concept will eventually apply naturally to China; i.e., separating emerging market allocations into China and ex-China components.

OPPORTUNITY FOR INCREASED EFFICIENCY

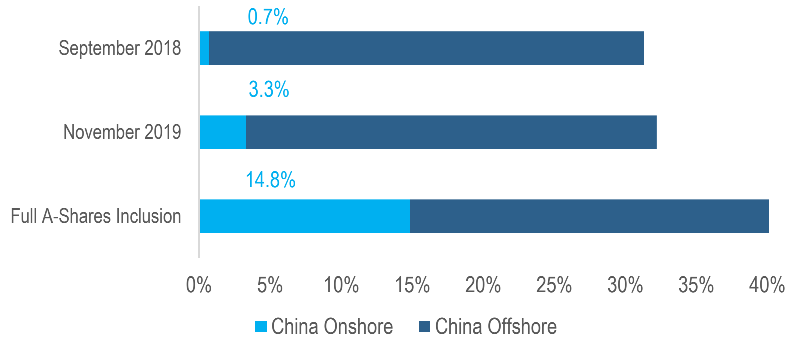
Relative to the offshore equity market, A-shares offer broader and deeper representation of the entire Chinese economy. The offshore market, which is half the size of the onshore market as measured by market capitalization, is concentrated largely in financial and information technology sectors; the result is a perpetual underweight in consumer-driven segments of the world's most populous country. China A-shares' wider opportunity set, coupled with its exposure to the full economy and persistently lower levels of systematic risk to both developed and emerging equity markets (Figure 5), may offer global investors the increasingly rare opportunity to improve the efficiency of their public equity strategic asset allocations.

[3] Copyright MSCI 2019. All Rights Reserved. Unpublished. PROPRIETARY TO MSCI.

[4] A-shares, H-shares, other non-Chinese listed securities.

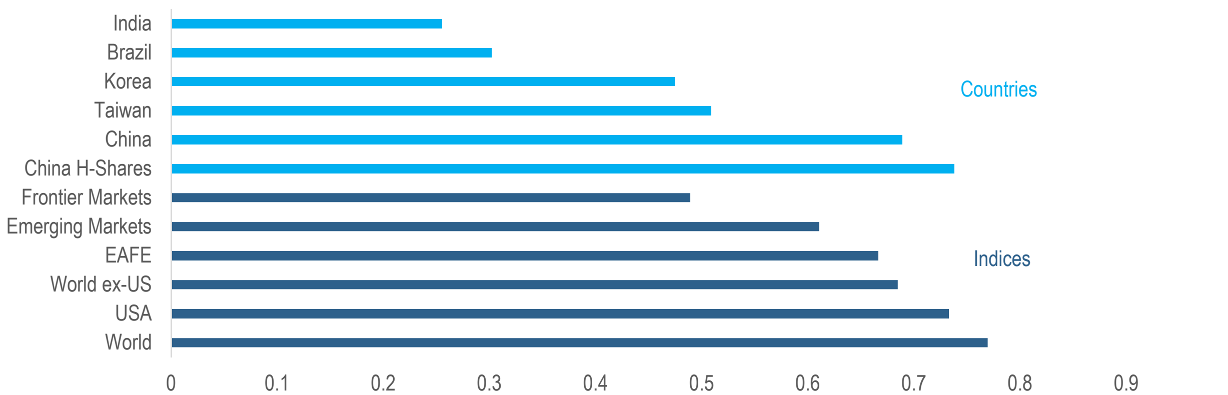
[5] As of January 31, 2019.

FIGURE 4: MSCI EMERGING MARKETS INDEX



Source: MSCI. Copyright MSCI 2019. All Rights Reserved. Unpublished. Proprietary to MSCI. For illustrative purposes only. It is not possible to invest directly in any index.

FIGURE 5: MSCI CHINA A-ONSHORE INDEX CORRESPONDING BETAS



Betas are average of rolling 3-year beta based on monthly returns from 2001 to 2018. Source: MSCI, Acadian analysis. Copyright MSCI 2019. All Rights Reserved. Unpublished. Proprietary to MSCI. For illustrative purposes only. It is not possible to invest directly in any index.

CONCLUSION

China's broad and diverse onshore equity market, the second largest in the world, made critical steps toward gaining foreign investment in 2018. We expect further progress in the year ahead as globally relevant benchmarks increase their holdings. From both a tactical and strategic perspective, we believe an allocation to onshore Chinese equities offers global investors the ability to improve their investment programs. This attractive opportunity comes with a distinct set of risks; nevertheless, we believe, that the Year of the Pig brings opportunity for sophisticated investment strategies that will extend into the years of the Rat (2020), Ox (2021), Tiger (2022) and beyond.

BIOGRAPHIES

BIN SHI, PH.D., CFA

SENIOR VICE PRESIDENT, PORTFOLIO MANAGER, RESEARCH

Bin joined Acadian in 2006. His responsibilities include portfolio management, research on stock selection signals and models for both developed and emerging markets, and enhancements to the Acadian investment process. Prior to Acadian, Bin was a statistician at Mathworks, where he contributed machine learning algorithms to financial and statistics toolboxes in Matlab. Early in his career, he applied machine learning techniques in transportation, manufacturing, and health care. Bin also previously worked as a consultant at Magna International, helping to develop smart driving algorithms. He holds a Ph.D. in industrial and systems engineering from Georgia Institute of Technology and an undergraduate degree from Southeast University in China. Bin is a CFA charterholder.

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Joe joined Acadian in 2013 and is a product strategist in Acadian's Client Solutions and Product Strategy Group. Part of his responsibilities include product development, analysis, and positioning. Prior to his current role, Joe worked in the Global Client Group focusing on new business development efforts and existing client relationships, and prior to that role was a senior RFP writer. Before joining Acadian, he worked at The Boston Company, State Street Global Advisors, and International Fund Services. Joe holds an M.B.A. in asset management and an M.S. in finance from Boston College and earned a B.A. in business administration and rhetorical theory from the University of Pittsburgh. He is a CFA charterholder and a member of CFA Society Boston.

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