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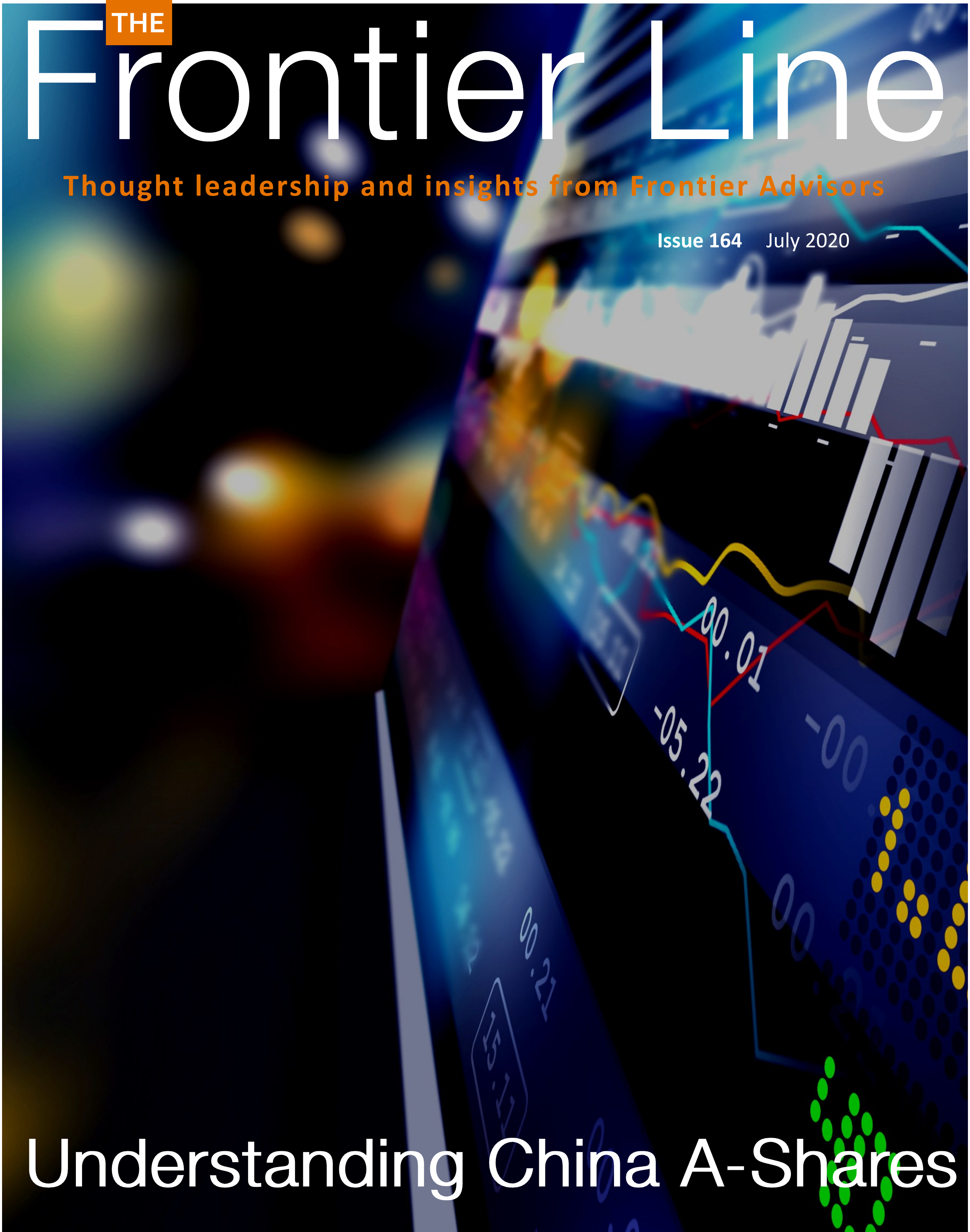

Understanding China A-Shares

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Introduction

The objective of this paper is to provide an introduction to China A-Shares, Chinese domestic equities listed in mainland China, where we seek to analyse the market's unique characteristics as well as the underlying opportunities and risks.

The China A-Shares market, as represented by the Shanghai Stock Exchange and the Shenzhen Stock Exchange, is the world's second largest equity market after the US by market capitalisation. With over 3,000 listed securities, the combined market cap of the Shanghai and Shenzhen markets stood at US$8.4 trillion, as at end of January 2020. This compares to US$8.2 trillion for the Dow Jones Industrial Average and US$14.4 trillion for NASDAQ.

While foreign ownership in China A-Shares is currently relatively limited, this is expected to change in the future with China A-Shares increasingly becoming part of the Australian institutional investor's universe given improved foreign access to domestic Chinese equities and increased representation of the A-Shares class in global equity indices. Moreover, China A-Shares appear an attractive investment opportunity and Australian institutional investors have scope to improve returns with greater China A-Share investment in the future.

Executive summary

Too large to ignore

Chinese authorities' efforts to improve foreign accessibility to the once-restricted Chinese domestic equities through mechanisms like Stock Connect and QFII/RQFII to lesser extent paved the way for the inclusion of China A-Shares in major global equity indices. In fact, the weight of China A-Shares, which currently stands at 4% of MSCI EM index, can potentially quadruple to 16% in the event of full inclusion by MSCI. This, combined, with the large and liquid nature of the market and the growing role that China plays in the global economy means that investing in China A-Shares will form an important part of foreign institutional investors' strategy for their overseas equity portfolios.

A return-enhancing opportunity

The unique characteristics of China A-Shares provide Australian institutional investors with a potential return-enhancing opportunity. Firstly, the composition of the MSCI China A-Shares index provides investors with access to domestically-orientated companies in the Industrials, Information Technology, Consumer Staples and Healthcare sectors which are well positioned to benefit from the structural growth of China's "new" economy. Secondly, Chinese domestic equities provide diversification benefits for global investors given low correlation with most equity markets. Thirdly, the behavioural biases and high volatility associated with the retail investor dominance makes the market a potentially fertile ground for alpha harvesting through active management as fundamental research appears likely to be rewarded.

Market inefficiency implies a higher risk/reward profile

Domestic Chinese companies are typically associated with relatively poor corporate governance standards including lack of transparency, weaker corporate access, and poor accounting practices, all representing characteristics of an inefficient market. Moreover, emotional biases which tend to cloud retail investors' trading activity has historically resulted in higher volatility and larger drawdowns for the China A-Shares market compared to other equity markets. While these features imply a relatively high-risk profile, they also signal an opportunity for alpha generation which can be exploited through deep research and active ESG engagement by sophisticated investors. While a passive investment approach provides a low-cost way of getting access to this highly diverse market, it does not enable capturing the inefficiency of the market. Frontier recommends investors adopt an active management approach towards China A-Shares as the market's unique characteristics imply a high potential for alpha generation through good stock picking skills

Accessing China A-Shares via a global ACWI portfolio is not a viable option in most instances

While access to China A-Shares through MSCI ACWI managers presents a possible alternative, Frontier notes that those managers typically spend minimal time analysing the China A-Shares market and have limited exposure to China A-Shares. This can reflect their inexperience with the market, but also the large ACWI opportunity set and the relatively small weight to China A-Shares in the MSCI ACWI index (at ~0.5%).

While not without its challenges (today), exposure to China A-Shares through Emerging Market (EM) managers with capabilities and willingness to invest in domestic Chinese Equities will be the preferred approach for most clients going forward.

This approach has many conveniences particularly given that most clients have a dedicated allocation to EM within their International Equities portfolios. In contrast, investing directly in China A-shares has many complexities and governance considerations that might be prohibitive for some clients. A current limitation of the approach is the low level of China A-shares exposure for most EM managers. We expect this will change as most EM managers have started to commit more to China A-Shares given its growing significance within their universe.

Clients may wish to obtain an additional allocation to China A-Shares over and above exposure obtained through EM managers

This may be as part of a satellite/opportunistic return generating strategy, or a completion strategy on the expectation that the China A-Shares exposure will be low if relying on EM managers. For clients seeking a more substantive exposure to China A-Shares, the options include Asian equities, Greater China equities and a China A-Shares specialist manager. With regards to Asian equities and Greater China managers, we have noted that their holdings in China A-Shares tend to be concentrated in widely-owned and researched domestic Chinese stocks, thus reducing the attractiveness of exploring this alternative (i.e. the approach is not that different to what is achieved via EM managers, where allocations to A-Shares are made).

Therefore, for clients seeking a significant targeted exposure to China A-Shares, Frontier considers a dedicated allocation to a specialist China A-Shares manager to be most appropriate

We do, however, note that such an allocation would be difficult for some clients as the relative complexity and governance issues underlying an investment in China A-Shares require considerable time and heightened levels of due diligence and ongoing monitoring

History of foreign access into China A-Shares

Chinese authorities have launched a number of initiatives to enable foreigners to access China's once restricted equity market, in an attempt to increase foreign participation in China's domestic capital markets.

The journey started in November 2002 with the launch of the Qualified Foreign Institutional Investor Scheme (QFII) which enabled foreign investors to transfer international capital onshore to invest in Chinese equities, bonds, mutual funds and stock index futures. In 2011, a similar scheme known as Renminbi Qualified Foreign Institutional Investor Scheme (RQFII), was launched with the main difference being that the offshore capital was RMB-denominated. It is worth noting that while the onshore Renminbi (CNY) is traded in mainland China based on a reference rate regulated by the People's Bank of China, the offshore Renminbi (CNH) is traded outside China and moves freely based on supply/demand mechanics. Both schemes required foreign investors to apply for a license and an investment quota before converting their capital from foreign currency (including offshore RMB) to onshore Chinese currency, a lengthy and restrictive process that many foreign investors did not find convenient.

The launch of HK-Shanghai Stock Connect in 2014 and HK-Shenzhen Stock Connect in 2016 marked a milestone in increasing foreign access into China domestic equities, paving the way for the A-Shares market to be included in major global indices. The Stock Connect is a mechanism that enables global investors to invest in stocks listed on the Shanghai Stock Exchange and Shenzhen Stock Exchange through a cross-boundary investment channel connecting the Hong Kong Stock Exchange to each of the two onshore markets. Among the several benefits of Stock Connect compared to the QFII/RQFII schemes, the mechanism enables investors to maintain their accounts and brokerage services in Hong-Kong, has no funds under management minimum, track record or daily liquidity requirements and has an overall easier registration process. While a daily limit is imposed on total capital flow between HK and Mainland China, it is large enough not to pose any meaningful restrictions on individual institutions' trading activities.

In fact, according to Dimensional, foreign ownership of China A-Shares through Stock Connect, which stood at around US$120 billion in 2019, can be liquidated over two to three days as the market's average daily turnover stood at US$85.7 billion at the end of October 2019 (of which US$40.5 billion for Stock Connect).

In an attempt to revive the QFII scheme, the China Securities Regulatory Commission (CSRC) has relaxed several restrictions on the scheme including the removal of the quota limit (conditioned on State Council ratification), removal of the three-month lock-up period on repatriation of principal and 20% cap on repatriation of principal and profits from the QFII investments, and have now allowed foreign exchange hedging. While those reforms were seen as evidence that China policymakers are serious about facilitating foreign access to their markets, some investors argue that the removal of the quota does not have a major impact on increasing the attractiveness of the QFII/RQFII system, as only c. 37% of the total $300 billion quota was used as at August 2019[1]. Moreover, while those reforms attempt to facilitate the repatriation mechanism for foreigners, many hurdles continue to limit overseas investors' ability to repatriate their capital out of China. Additionally, many investors continue to find the requirement by the CSRC to use specific brokers (three on the Shanghai Stock Exchange and three on the Shenzhen Stock Exchange) as restrictive.

That being said, QFII/RQFII system offers investors some advantages over Stock Connect. These include the ability to participate in primary listings (such as IPOs) as well as the ability to trade a wider universe of securities including index futures thus offering investors a wider access to hedging tools. That is, the QFII/RQFII schemes enables global investors access to all listed equities (over 3,500 securities listed in Shanghai and Shenzhen) and stock index futures while the Stock Connect allows partial access to the broader investment universe covering around 2,000 securities across Shanghai, Shenzhen and Hong Kong markets.

[1] Feng, Rebecca. *"China reforms QFII, RQFII but leaves critical problems untouched"*. Global Capital. September 2019

Table 1: Stock Connect vs. QFII/RQFII

	Stock Connect (Northbound)	RQFII	QFII
Setup Time/ & Complexity	No regulatory approval to open an account Operational setup takes 2-4 weeks & relatively simple	Lengthy and in-depth regulatory application process Normally takes two to three months but can take up to a year	
Quota	Daily Net Buy Quota: RMB52 billion (A$11 billion) each for Shanghai and Shenzhen	No daily trading quota (conditional on State Council ratification)	
Coverage	Partial (around 1,200 for Stock Connect Northbound / 2,000 stocks across Shanghai, Shenzhen and Hong Kong)	Full access to all c3,500 stocks	
Trading Calendar	Both HK and mainland exchanges must be open, 10 trading days less per year than mainland calendar	Follows mainland calendar	
Currency	CNH but can also settle in CNY, USD or	CNH	USD and other
Broker List	Special Segregated Account (SPSA), Stock Connect's account ID process, allows for up to 20 HK-based brokers	Restricted list of 3 brokers per exchange	
Security Lending	Permitted with restrictions	Not permitted	

Source: Hong Kong Exchanges and Clearing Limited (HKEx), State Administration of Foreign Exchange, Citi Securities Services, Bloomberg, Dimensional

Overall, Stock Connect remains the primary access mechanism of foreign investors to the China A-Shares market with Stock Connect accounting for c. 65% of foreign ownership of China A-Shares as at June 2019 (HKEX, PBOC and Dimensional).

Chart 1: Net Flows into China Onshore Equities via Stock Connect

Bloomberg, Nipun Capital

MSCI inclusion of China A-Shares

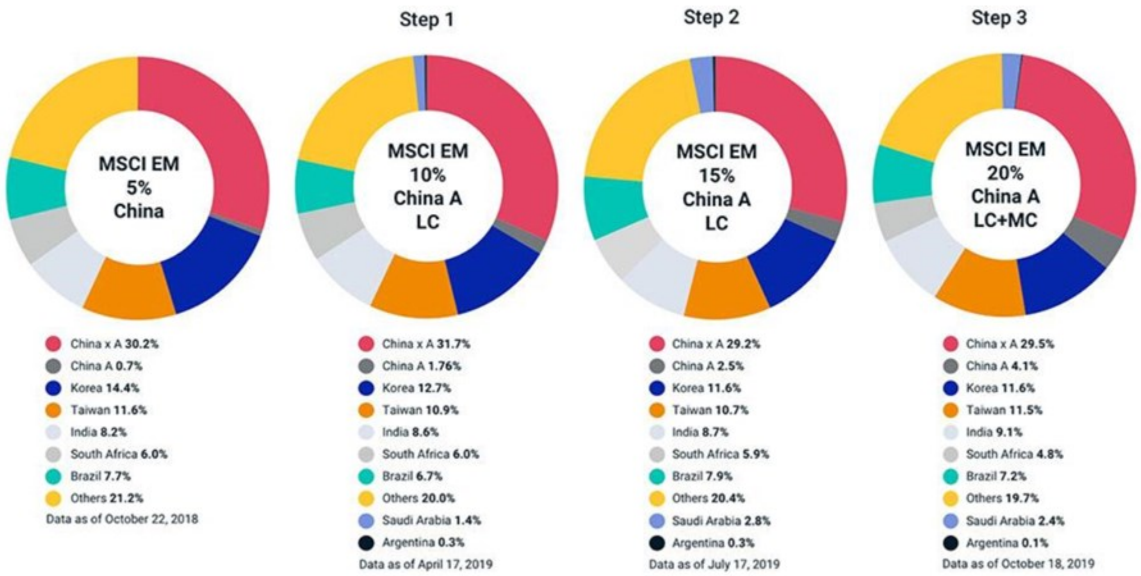
In June 2017, MSCI announced its decision to partially include China A-Shares in its MSCI China Index, MSCI Emerging Markets Index and MSCI ACWI Index. This was first implemented in May 2018 at an index inclusion factor (IIF) of 2.5% (for Large Cap shares), resulting in the addition of 234 China A-Shares to the MSCI EM Index, followed by an increase to the inclusion factor to 5% in August 2018. The IIF dictates how much of stock's free-float adjusted market capitalization is included in the index.

In February 2019, MSCI announced that it would further increase the weight of China A-Shares in its indices through a three-step inclusion process starting in May 2019 when the inclusion factor was raised to 10% from 5%. The second phase was completed in August 2019 with the increase in the inclusion factor to 15%. The next phase of the process took effect in November 2019, with the inclusion factor reaching 20%, resulting in a China A-Shares weight of 4.1% in the MSCI EM index, raising the total China weight to over 33.6% (as the weight of China ex-A-Shares which include H shares, B Shares, Red Chips, P chips and ADRs is at 29.5%).

This translates into 472 China A-Shares split into 244 large cap and 228 mid cap securities. It is worth noting that MSCI's consultation is focussed on the A-Shares class only as these were previously not accessible to foreign investors but improvement on that front has warranted inclusion in the index.

The growing weight of China A-Shares in MSCI indices resulted in a meaningful increase in the participation of international investors in Chinese domestic equities with Stock Connect accounts growing to 7,300 post-February 2019 MSCI's announcement compared to 1,700 Stock Connect accounts prior to MSCI's June 2017 announcement, according to Hong Kong Stock Exchange data.

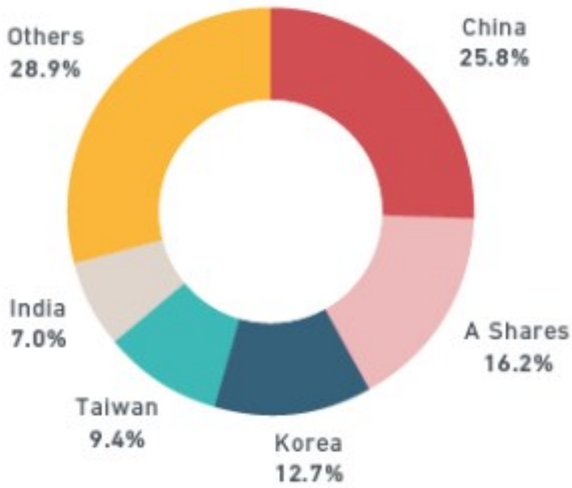
Chart 2: China A Shares Pro-Forma Weight in MSCI Emerging Markets Index



Source: MSCI

At the 20% inclusion factor, the weight of China A-Shares into MSCI ACWI stands at 0.5% with a total China weight of 4%. The pro-forma weight of China in MSCI ACWI would increase to 6%, in the event of full inclusion. In the event of full inclusion, China A-Shares weight would quadruple to 16% in MSCI EM Index (on pro-forma basis) implying a total weight of 40% for Chinese equities.

Chart 3: MSCI EM Index with 100% China A-Shares Inclusion Factor



Source: MSCI

In its press release in November 2019, MSCI highlighted that any further inclusion of China A-Shares in MSCI Indices requires progress to be made in relation to the following aspects highlighted by international institutional investors as areas of concerns. Those include the following:

Access to hedging and derivatives instruments

Access to derivative instruments has been subject to strict restrictions in China as short-selling of index futures was blamed for the market crash in 2015. Equity derivatives options currently available to foreign investors are limited to proxies available in overseas markets such as Hong-Kong listed stocks, exchange traded-funds (ETFs) or structured products which are more difficult to trade and more expensive compared to standard derivatives products. A Singapore-listed futures contract for the FTSE China A50 Index is the most widely used hedging tool for China A-Shares but only covers a small portion of the market. Chinese authorities have been working on increasing accessibility of equity hedging tools to foreigners as part of the plan to institutionalise China's capital markets.

In January 2019, the China Securities Regulatory Commission (CSRC) launched a consultation to combine the QFII/RQFII under a single scheme and broaden the investment scope for foreign investors by allowing access to derivatives, including financial futures as well as commodity futures and options.

In March 2019, the Hong Kong Stock Exchange announced that it would launch future contracts on the MSCI China A index that would track the entire large and mid-cap A-Shares included in the MSCI EM Index. The exchange has not specified a launch date which remains subject to regulatory approval and market conditions.

In August 2019, the China Financial Futures Exchange announced that it was easing restrictions on futures trading by proposing to remove the ban on unhedged bets against the market and by introducing an equity volatility index that will serve as the basis for derivatives contracts.

We highlight that all of the above initiatives are a step in the right direction. However, implementation remains to be seen.

Short settlement cycle for China A-Shares

China A-Shares currently trade on T+0/T+1 non-Delivery versus Payment (non-DVP) settlement cycle. This compares to a T+2/T+3 DVP settlement for most MSCI ACWI markets. The shorter settlement cycle for China A-Shares creates operational challenges and risks for foreign investors as the T+0 cycle implies that cash has to be received by the exchange on the trade date which creates pressure on middle office, back office and custodian workflows and timelines particularly in light of time differences between China, Europe and North America[2].

Trading holidays of Stock Connect

The Shanghai and Shenzhen stock markets follow different holiday schedules compared to the Stock Connect. That is, for investors to be able to trade through Stock Connect, both the Hong Kong and Mainland markets need to be open for trading and banking services need to be available in Hong Kong and Mainland markets on the corresponding settlement dates. This misalignment creates additional operational hurdles for international investors who rely on Stock Connect as the main trading mechanism to access A-Shares. While authorities are working on aligning the trading schedule of Stock Connect with banks and exchanges is Hong Kong and Mainland, progress is yet to be see on that front.

Availability of omnibus trading mechanism in Stock Connect

The absence of a "well-functioning" omnibus mechanism that enables brokers to place a single order on behalf of multiple client accounts has been highlighted by MSCI as an area of concern as such a mechanism allows for best execution and reduces operational risks for investors.

[2]Oellers, Peter. *"Overcoming the T+0 Settlement Cycle in China."* Global Investors Group. August 2019.

Comparison of MSCI China and MSCI China A-Indices

MSCI China A-Shares Index offers investors a more diversified investment opportunity set compared to the MSCI China Index which consists of large and mid-cap China A-Shares (at 20% of their free-float adjusted market capitalization), H shares, B shares, Red chips, P chips and foreign listings (such as ADRs).

Table 2: Guide to Chinese Share Classes

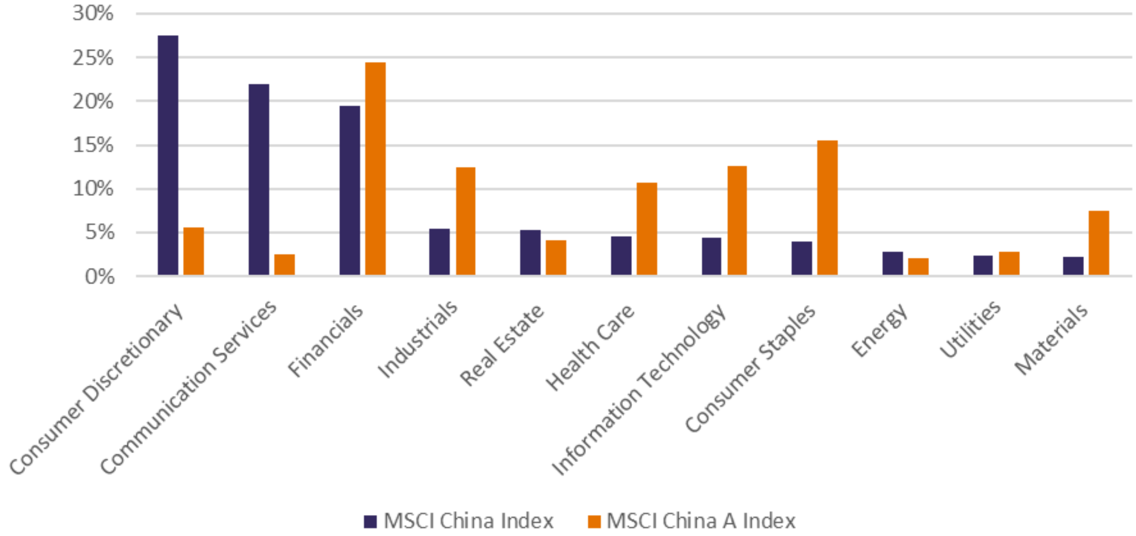
Share Class	Country of Incorporation	Country of Listing	Exchange	Trading Currency	Available to mainland Chinese Investors	Available to other investors	MSCI Index
A Share	People's Republic of China (PRC)	China	Shanghai and Shenzhen	CNY	Yes	Yes. Under QFII/ RQFII/ Stock Connect programs	MSCI China A, MSCI China A Onshore, MSCI China, MSCI EM, MSCI Asia ex Japan, MSCI ACWI
B Share	People's Republic of China (PRC)	China	Shanghai and Shenzhen	USD (Shanghai) HKD (Shenzhen)	Yes (if they have appropriate currency	Yes	MSCI China, MSCI EM, MSCI Asia ex Japan, MSCI ACWI
H Share	People's Republic of China	Hong Kong	Hong Kong	HKD	Yes, if QDII approved or under Stock Connect	Yes	
Red Chip	Non-PRC	Hong Kong	Hong Kong	HKD	Yes, if QDII approved or under Stock Connect	Yes	
P Chip	Non-PRC	Hong Kong	Hong Kong	HKD	Yes, if QDII approved or under Stock Connect	Yes	
S Chip	Non-PRC	Singapore	Singapore	SGD	Yes, if QDII approved	Yes	FTSE indices
N Share	Non-PRC	United States	NYSE/ NASDAQ	USD	Yes, if QDII approved	Yes	FTSE indices

Source: FTSE Russell. QDII: Qualified Domestic Institutional Investor, a scheme that provides domestic investors access to foreign markets.

As chart 4 below indicates, the MSCI China Index is largely concentrated in three sectors, Consumer Discretionary (27.5%), Communication Services (22.0%) and Financials (19.4%) which combined account for c69% of the index weight.

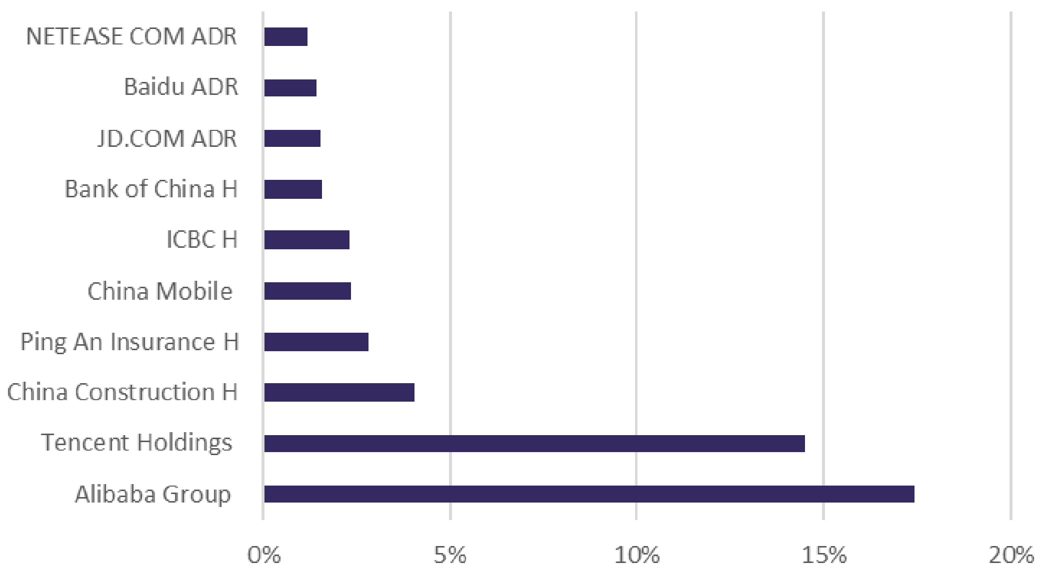
As can be seen in chart 5, security concentration is also high with the MSCI China index's top 10 constituents accounting for 49.1% of total index weight as at March 2020 and the largest two index constituents, Alibaba at 17.4% and Tencent at 14.5%, accounting for over 30% of index weight.

Chart 4: MSCI China versus MSCI China A-sector composition



Source: MSCI, as at 31 March 2020

Chart 5: MSCI China Top 10 Constituents (31 March 2020)



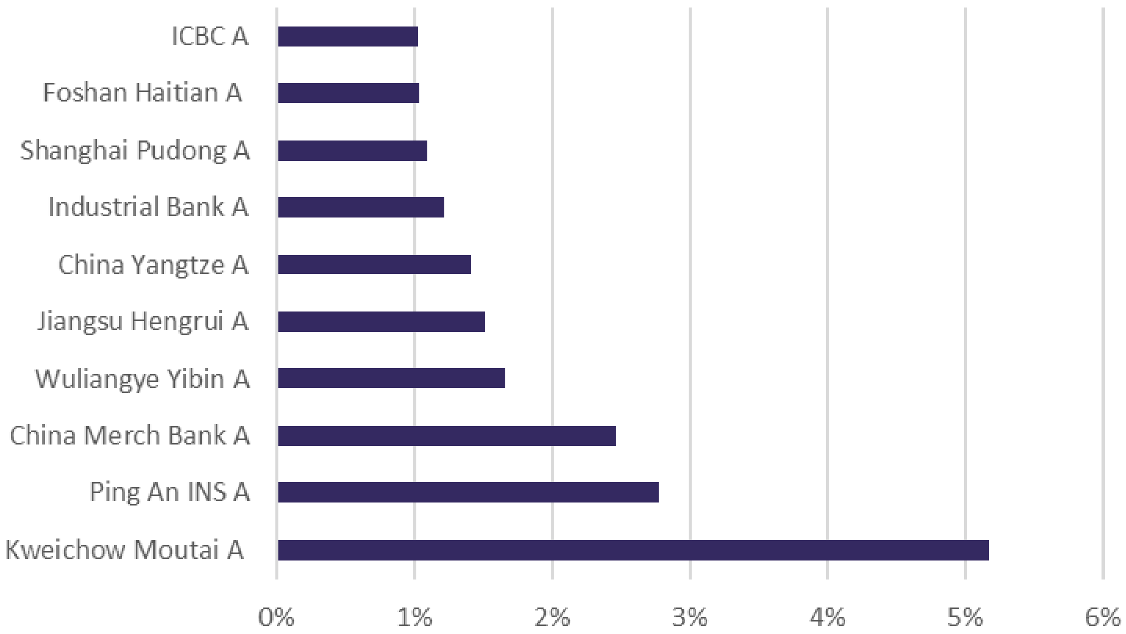
Source: MSCI

Aside from its large weight in the financial sector, the MSCI China A-Shares index is more diversified and balanced across sectors. The China A-Shares index has a meaningful weight in Consumer Staples, Information Technology, Industrials and Health Care which are well positioned to benefit from the structural growth of China's "new" economy and therefore, provide investors with an opportunity to capitalise on the growing Chinese middle class which emerged as a result of the exponential growth in Chinese GDP per capita over recent decades.

Overall, China A-Shares companies are more geared to the underlying fundamentals of the domestic economy, implying a lower exposure to global trends[3]. At the stock level, diversification is also higher with the Top 10 Index Constituents accounting for 19.4% of total MSCI China A index weight.

In terms of market capitalisation, the China A-Shares market is dominated by small and mid-cap companies as opposed to large-cap representation of over 60% for H-shares and offshore listings.

Chart 6: MSCI China A-Shares top 10 constituents (31 March 2020)



Source: MSCI

[3]Lazard Perspectives. *"China A-Shares: An Opportunity in Strategic exposure."* 1 October 2019.

Characteristics of China A-Shares market

Chinese authorities have launched a number of initiatives to enable foreigners to access China's once restricted equity market, in an attempt to increase foreign participation in China's domestic capital markets.

Large and liquid market

The China A-Shares market, as represented by the Shanghai Stock Exchange and the Shenzhen Stock Exchange, is the world's second largest equity market after the US by market capitalisation. With over 3,000 listed securities, the combined market cap of the Shanghai and Shenzhen markets stood at US$8.4 trillion, as at end of January 2020. This compares to US$8.2 trillion for the Dow Jones Industrial Average and US$14.4 trillion for NASDAQ. Moreover, the China A-Shares market is characterised by ample liquidity with a combined average daily value traded for A-Shares (traded through QFII, RQFII and Stock Connect) of US$85.7 billion (as at 31st October 2019).

This compares to an average daily turnover of US$ 4.3 billion for Australia and exceeds the average daily turnover of Japan, Korea, Hong Kong, UK, Germany, India, Taiwan, France, Switzerland and Australia combined (Dimensional).

Low correlation with global equity markets

The China A market provides investors with diversification benefits given low correlation with global equity markets. In fact, the MSCI China A Index has half the correlation to MSCI EM compared to MSCI China H and a lower correlation to MSCI World ex Australia.

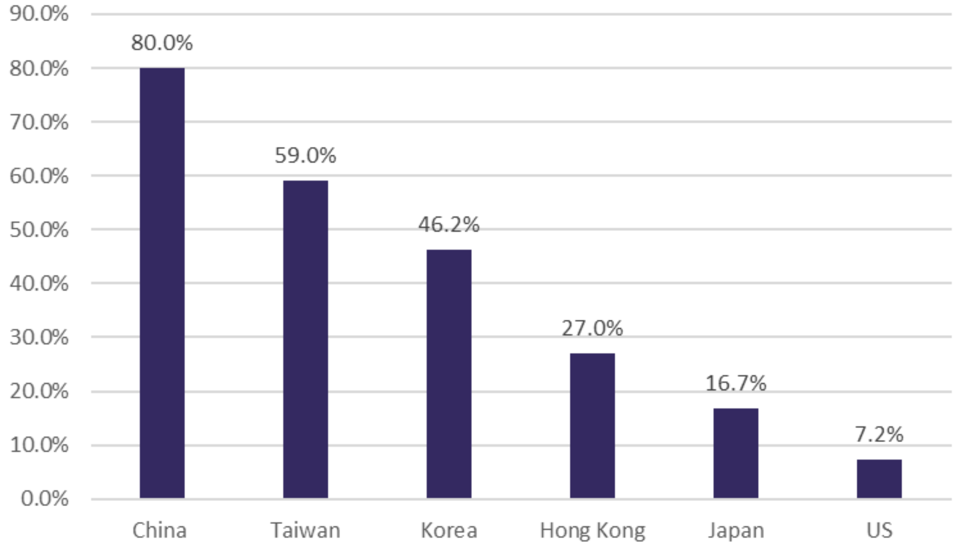
The low sensitivity of the China A market to global trends can be attributed to the market being dominated by less sophisticated retail investors who account for 80% of total trading volume and around 50% of the market's total free-float market capitalisation and whose trading activity is rarely driven by underlying fundamentals [4].

Table 3: Ex-ante correlation between MSCI China A and global equity indices (AUD)

	MSCI China A onshore	MSCI China H	MSCI EM	MSCI World ex Au	S&P/ASX 300
MSCI China A onshore	1.00	0.57	0.35	0.27	0.18
MSCI China H	0.57	1.00	0.72	0.33	0.43
MSCI EM	0.35	0.72	1.00	0.58	0.69
MSCI World ex Au	0.27	0.33	0.58	1.00	0.55
S&P/ASX 300	0.18	0.43	0.69	0.55	1.00

Source: Bloomberg, Frontier (data from December 2004 to March 2020)

Chart 7: Retail investors' share of equity trading volume



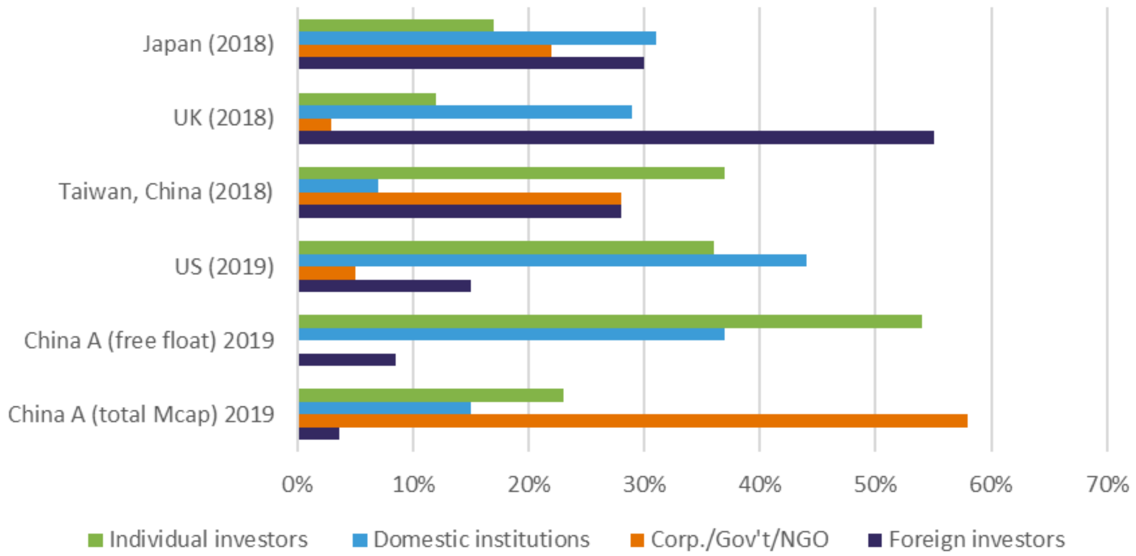
Source: CEIC, Citi Strategy Research, Invesco. Data as of June 2019

[4] Lu, Jie. *"Five Reasons for Strategic Allocation to China A-shares."* Robeco. 8 May 2019.

Moreover, foreign ownership in China A-Shares remains relatively low compared to other markets as the history of foreign access reforms is relatively recent. In fact, according to Robeco, foreign ownership in China A was limited at 3.6% compared to 30% for Japan and 15% for the US, based on the most recently available data.

This has meant that the market is more domestically focussed and less sensitive to global trends, a feature that is expected to change as foreign participation gradually increases over time. Additionally, the index composition which is skewed towards domestically-orientated companies also helps explain the low correlation to global markets.

Chart 8: Foreign ownership across global stock markets

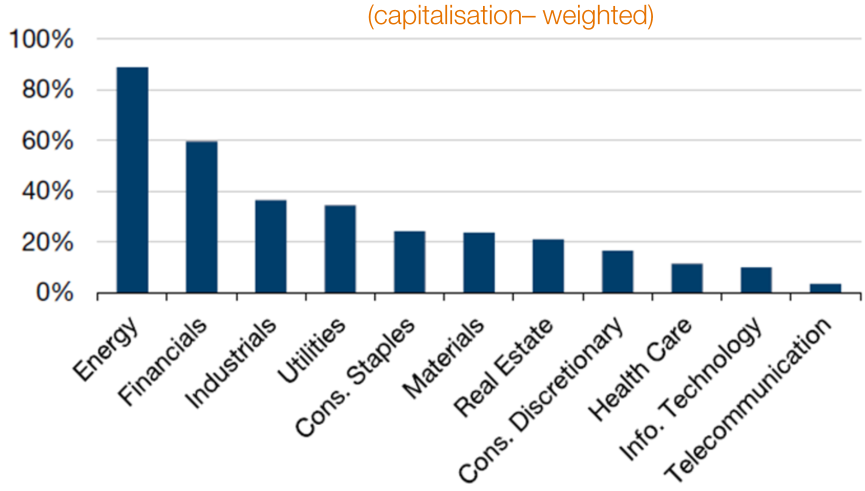


Source: Federal Reserve, ONS, CEIC, NSE, SSE, Wind, CICC Strategy Research and Robeco.

Dominance of State-owned enterprises (SOEs)

State-owned enterprises dominate large aspects of the Chinese economy and control c. 30% of the market capitalisation of the A-Share market[5]. The dominance of SOEs is particularly pronounced in "Old Economy" sectors such as the Energy and Financials sectors of the China A-Shares market where state ownership has comfortably exceeded 50% given the strategic importance of those sectors and their regulated nature[6]. This might pose some sensitivities for certain stocks from an ESG perspective as well as potential legal challenges in the event of a dispute/issue arising.

Chart 9: : Percentage of government ownership by sector (capitalisation– weighted)



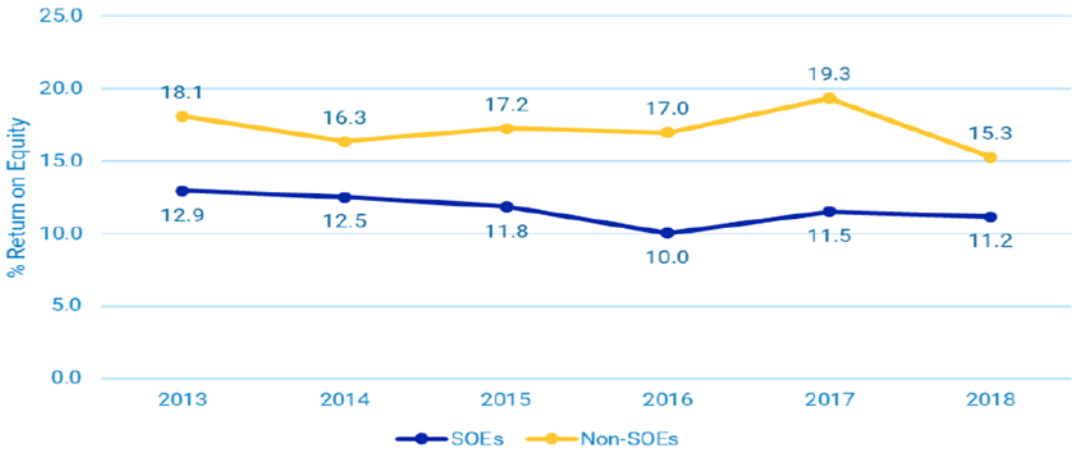
Source: Man Numeric, Bloomberg. Based on Man Numeric China A universe as of December 2016

[5]Ralston, Gavin, and Mee, Kristjan. *"A New Approach to Investing in Emerging Markets."* Schroders. March 2019.
[6]Nouvellon, Mickael, and Ben-Akiva, Ori. *"Are China A-Shares an Opportunity For Investors?"* Man Numeric. February 2018.

In 2003, the Chinese government established the State-owned Asset Supervision and Administration Commission (SASAC) with the aim of overseeing the reform and restructuring of SOEs, as part of the government's initiative to institutionalise and increase foreign participation in its markets. In August 2018, SASAC launched the "Double Hundred Action" work plan which aims at accelerating reforms across 400 SOEs, including 110 listed companies, from central and local SOEs over 2018-2020 period, with the purpose of aligning state goals with commercial goals[7].

While the impact of those reforms is yet to be seen, they are a step in the right direction towards reducing government's influence and increasing the competitiveness of SOEs. As shown in Chart 10, SOEs have historically had lower Return on Equity.

Chart 10: Return on equity for MSCI China index SOEs vs. Non-SOEs



Source: Ownership Structure/TSR Data, MSCI ESG Research and Thomson Reuters Data as of July 8, 2019, Company reports.

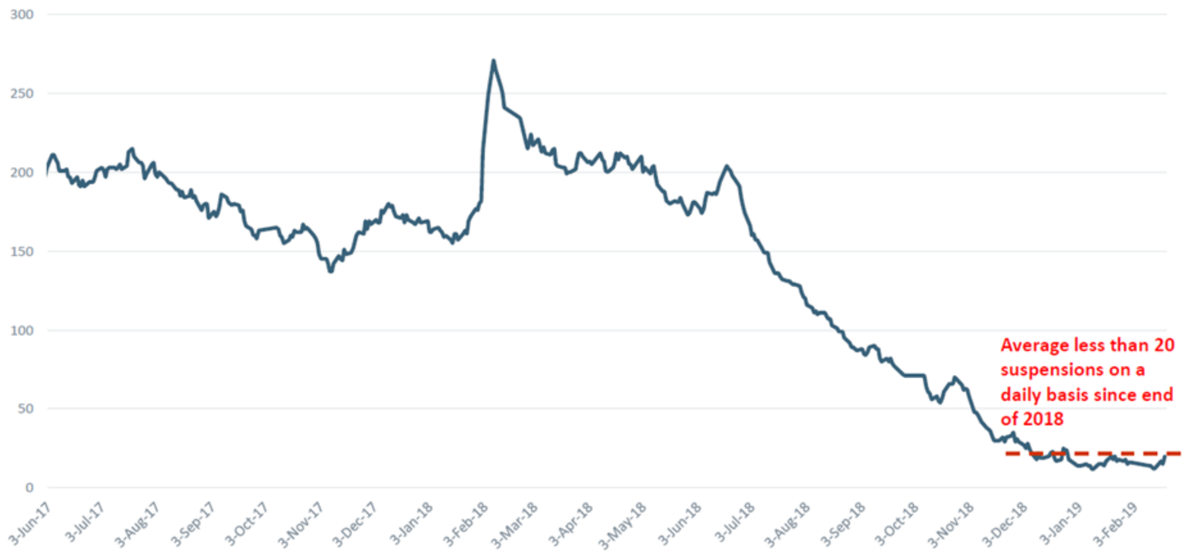
[7]Wang, Xiaoshu, Hu, Jingmin, and Chen, Gongyu. "*China Through an ESG Lens.*" MSCI. September 2019.

Improving trading mechanisms but some inefficiencies remain in place

Trading suspensions in China A-Shares have posed a concern for investors as well as index providers given the frequency and length of duration. Trade suspensions reached their peak in July 2015 amid the sharp market sell-off with more than half of listed firms halting trading on their shares. However, the number of trading suspensions has been declining significantly as a result of stricter regulations imposed by Chinese authorities. These rules, which were implemented in November 2018, limited the acceptable reasons for stock suspensions, shortened the maximum suspension duration and increased disclosure requirements associated with suspensions.

Having said that, the market still has in place daily limits on up and down price movements for single stocks which, when reached, trigger a halt on stock trading for that day. This, in addition, to extended periods of market closure dictated by the regulator in response to high market volatility continue to pose concerns for foreign investors. The most recent example is the decision by Chinese authorities to extend the market's shut down for three days on top of the announced Lunar New Year holiday in January 2020 on COVID-19 virus related concerns. A similar approach was undertaken during the SARS outbreak in 2003 when a May Day holiday market shut down was extended by four trading days.

Chart 11: Number of stocks with a trading suspension in China A-Shares since June 2017



Source: MSCI. Based on the full China A-Shares universe of over 3,000 securities.

China A-Shares return & risk metrics

The MSCI China A Index generated returns of 8.9% p.a. (unhedged in AUD) over the one-year period ending March 2020, meaningfully outperforming the MSCI China H and MSCI EM indices. Longer-term performance of A-Shares has been a mixed bag with the noticeable relative underperformance over the five-year period to March 2020 being likely due to the China stock market crash in 2015. It is worth noting that the MSCI China A Index only covers large and mid-cap A-Shares that are accessible via Stock Connect while the MSCI China A Onshore Index covers all Chinese securities listed in Shanghai and Shenzhen.

While retail dominance in China A-Shares has been positive in boosting market liquidity, it has resulted in higher market volatility as retail trading decisions tend to be sentiment-driven with shorter time horizons. Emotional biases which tend to cloud retail investors' trading activity help explain the higher volatility and larger drawdowns of the China A-Shares market[8].

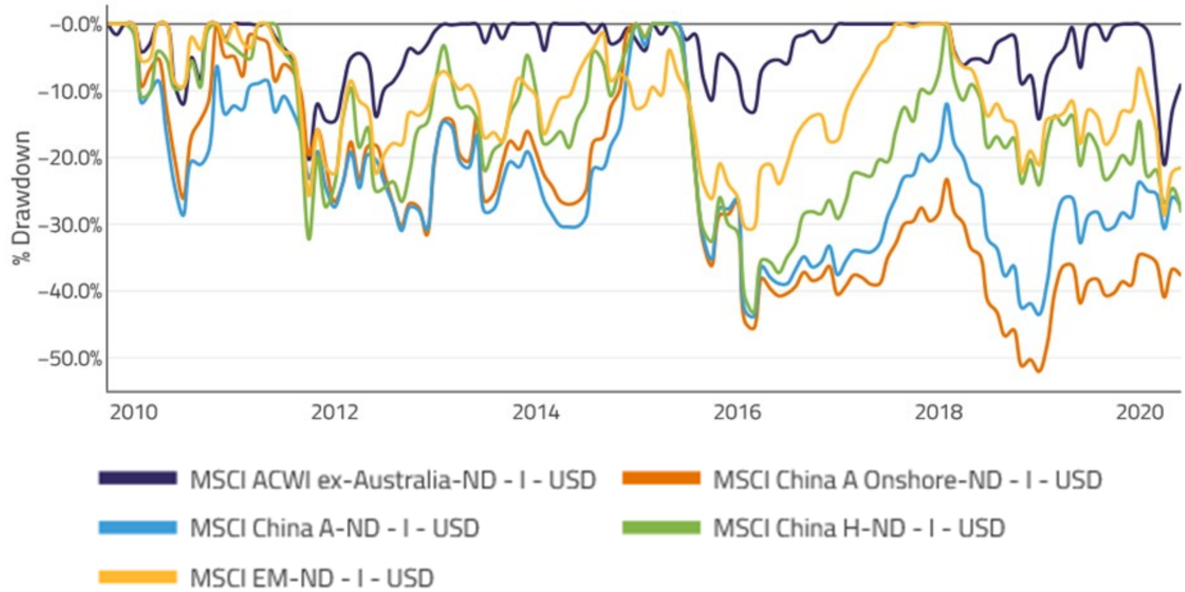
Sharp market movements can also be exacerbated by government intervention in the market through what is known as "the national team" which was formed in 2015 and comprises of large state-owned institutional investors whose trading activities aim at stabilizing the market.

Table 4: Comparison of indices return and risk metrics to 31 March 2020 (AUD)

Returns	QTD (%)	1 year (%)	3 yrs (% p.a.)	5 yrs (% p.a.)	7 yrs (% p.a.)	10 yrs (% p.a.)
MSCI China A Onshore	3.7	7.5	5.9	-2.0	11.7	5.0
MSCI China A	4.3	8.9	9.4	0.9	13.4	6.3
MSCI China H	-1.7	0.0	7.9	2.9	9.9	5.1
MSCI EM	-12.3	-4.5	5.9	4.2	7.5	4.8
Volatility	**QTD (%)**	**1 year (%)**	**3 yrs (% p.a.)**	**5 yrs (% p.a.)**	**7 yrs (% p.a.)**	**10 yrs (% p.a.)**
MSCI China A Onshore	14.3	12.0	16.6	21.1	24.5	23.8
MSCI China A	10.8	11.7	16.0	20.4	24.2	23.3
MSCI China H	18.6	13.9	14.7	17.8	17.7	18.0
MSCI EM	20.5	15.4	11.9	11.5	10.6	10.7

Source: eVestment, Frontier Advisors

Chart 12: Drawdown of MSCI China A-Shares versus other markets



Source: eVestment, Frontier Advisors

[8]Tian, Hanqing and Sen, Anik. *"China A-Shares: Perspectives From The Inside Out."* PineBridge Investments. 17 December 2019

ESG considerations for Chinese equities

Governance

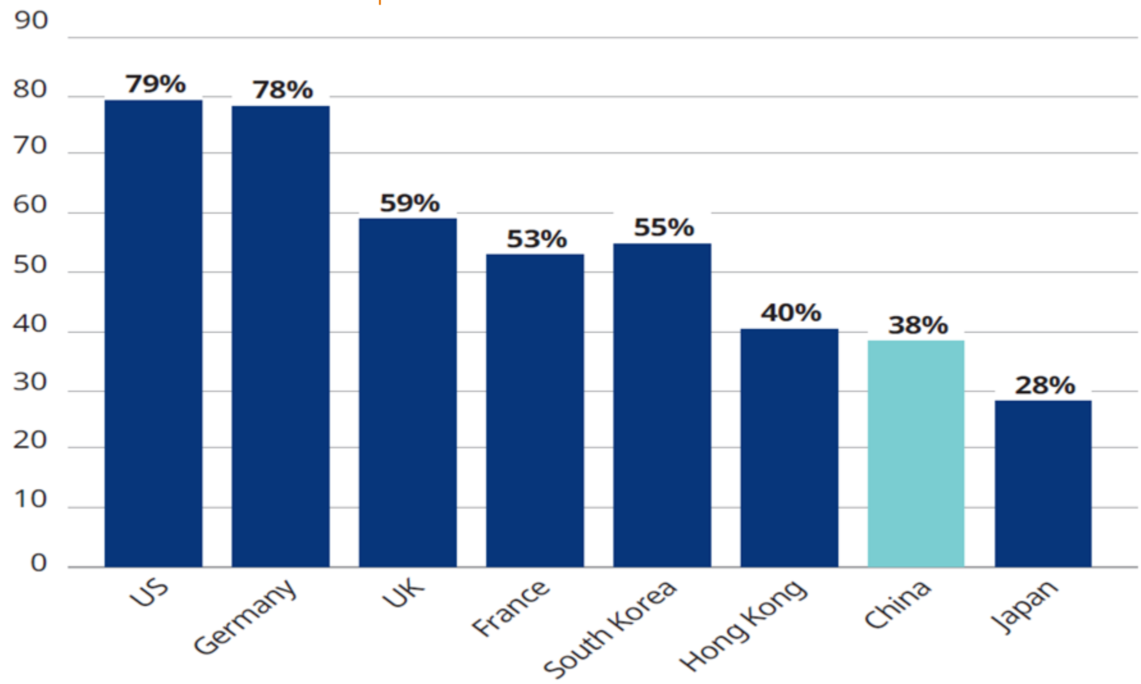
Domestic Chinese companies are typically associated with relatively poor corporate governance standards. For instance, the representation of independent members within the board of directors of Chinese companies is relatively low compared to other markets resulting in less rigorous oversight of management teams. Moreover, in addition to a large control by SOEs, the presence of a controlling shareholder characterises many listed Chinese companies.

This combined with a lack of equity incentives for CEOs creates little alignment between management and controlling shareholders' goals and the interest of minority shareholders [9]. Additionally, key person risk arises in situations where the controlling shareholder also plays a pivotal leadership role in the board or management of the company.

Accounting irregularities, poor disclosure and stock pledge risk in founder firms comprise additional sources of governance risks with the latter being particularly common in China A-Shares where key shareholders use their shares as collateral to obtain cheap loans. According to MSCI ESG Research, about 10% of the China A-Shares market capitalisation (equivalent to US$615 billion) at the end of 2018 had been pledged exposing minority shareholders to large losses in the event of forced liquidation[10].

China's delisting regulations resulted in many companies resorting to "big bath" accounting practices which involves booking oversized losses in the near-term to avoid reporting consecutive losses as three consecutive years of losses lead to trading suspension and four consecutive losses result in delisting.

Chart 13: Independent Directors: China A-Shares vs. Other markets



Source: Schroders, Thomson Reuters DataStream. Data as at February 2019.

[9] Ralston, Gavin, and Mee, Kristjan. "*A New Approach to Investing in Emerging Markets*." Schroders. March 2019.
[10] Wang, Xiaoshu, Hu, Jingmin, and Chen, Gongyu. "*China Through an ESG Lens*". MSCI, September 2019.

Environmental

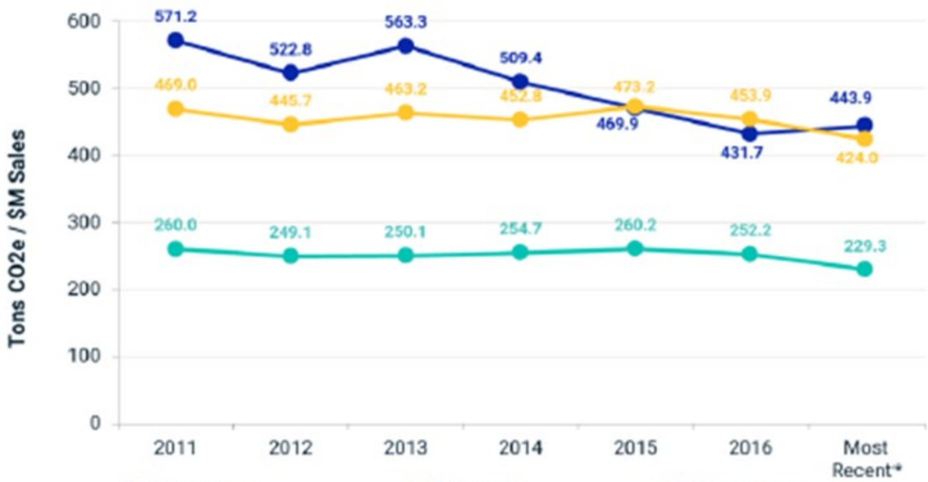
China is the world's largest CO2 gas emitter, accounting for more than one quarter of emissions. As part of the Paris Agreement, China has committed to reduce its carbon emissions intensity by 60% to 65% by reducing its coal consumption through the transition to natural gas and increasing its investments towards renewable energy. In March 2018, the Chinese government announced that it has achieved its target under the Copenhagen Accord which entailed reducing carbon intensity by 40% to 45% and increasing the share of non-fossil fuel in the energy mix to 15%. Moreover, data released by the National Statistics Bureau indicates that China's coal usage in the nationwide energy mix fell below 60% for the first time in 2018[11], a positive sign that the country could hit its target of 58% by 2020.

Carbon-intensive companies in the Energy, Utilities and Materials sectors which accounted for 12% of the MSCI China A Index as at 31 March 2020 are likely to face stricter regulations in the medium-term as the country moves towards achieving its carbon reduction target. Overall, China's environmental impact appears to be on course for future improvements.

Social

Human rights and Labour issues constitute front of mind risks for investors when considering an allocation towards Chinese equities. However, talent management has been a recent focus for Chinese companies as the economy shifts away from traditional labour-intensive industries towards talent-intensive service industries in the financials, health care, information technology and telecommunication sectors[12].

Chart 14: Carbon intensity trend



Source: MSCI ESG Research as of August 2019. * Most Recent refers to the most recently available data for each company on the day MSCI ran the report. Portfolio level Carbon Intensity is the ratio of the portfolio's carbon emissions normalized by the investors' claims on sales.

Table 5: China pledges and targets

Agreement	Targets	Target Date
Copenhagen Accord	Carbon intensity reduction of 40% to 45% below 2005 levels	2020
	Increase the non-fossil fuel share of energy supply to 15%	
Paris Agreement	Peak CO2 emissions	2030
	Carbon intensity reduction of 60% to 65% below 2005 levels	
	Increase the non-fossil fuel share of energy supply to 20%	

Source: The Climate Action Tracker

[11] Daly, Tom and Xu, Muyu. *"China's 2018 Coal Usage Rises 1 percent, but Share of Energy Mix Falls."* Reuters. 28 February 2019.
[12] Wang, Xiaoshu, Hu, Jingmin, and Chen, Gongyu. *"China Through an ESG Lens."* MSCI. September 2019.

Active management in China A-Shares

The unique characteristics of the China A-Shares market, particularly in relation to retail dominance and the associated behavioural biases and high volatility, makes it a potentially fertile ground for alpha harvesting through active management as fundamental research appears likely to be rewarded. Further, there is scope that active engagement with companies on ESG risks could help with value creation.

The median China A-Shares manager delivered strong excess long-term returns both compared to the MSCI China A Index and the MSCI EM Index, as can be seen in the eVestment table below. We note, however, that the eVestment universe for China A-Shares managers has undergone material changes over the past few years with a large number of managers added to the universe, often seeking inclusion given their strong nearer term performance history. This renders the results below less reliable, in our view.

Table 6: China A-Shares managers excess return versus MSCI China-A Index (30 June 2019)

	1 year (%)	3 years (% p.a.)	5 years (% p.a.)
Upper Quartile	2.7	10.0	9.2
Median	**-0.2**	**8.1**	**6.8**
Lower Quartile	-4.0	4.4	3.9
Observations	49	43	38
MSCI China A Index	11.0	7.4	16.9

Source: eVestment

Based on a study conducted by Rayliant Global Advisors, it has been concluded that institutional investors are better stock pickers within China A-Shares compared to retail investors. To reach this conclusion, the Manager compared the performance of the stocks with highest foreign holdings through QFII and Northbound Stock Connect to those with the lowest foreign holdings. The study which is based on monthly data from May 2004 to May 2019 revealed that stocks with the highest QFII holdings outperformed stocks with the lowest QFII holdings by 7.4% p.a.

Similar analysis for Northbound Connect Holdings (orders routed from HK to Mainland) shows an outperformance of 27.9% p.a. for stocks with the highest Northbound Connect Holdings noting, however, that the history of the data is much shorter with the study running from July 2016- May 2019[13].

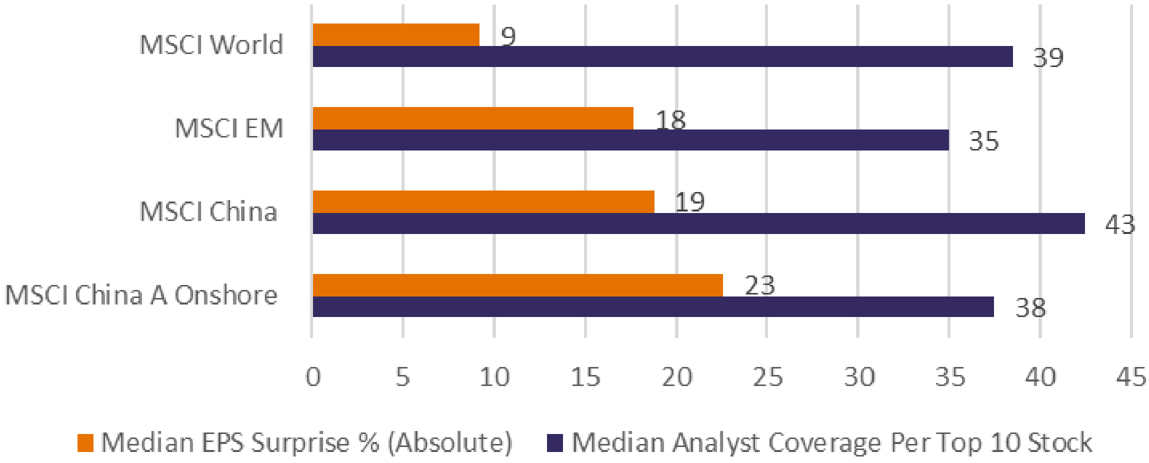
While the Median analyst recommendation per stock for MSCI China A Onshore Top 10 Index constituents is broadly similar to MSCI China, MSCI EM and MSCI World Indices, the median earnings per share (EPS) surprise is higher for MSCI China A Onshore compared to the other markets implying a poorer quality of coverage.

As indicated in Chart 16, 21% of MSCI China A Onshore Index companies reported earnings surprise greater than 50%, in absolute terms, as compared to consensus estimates, compared to 16% for MSCI China, 19% for MSCI EM and 11% for MSCI World Indices. The poorer quality of analyst coverage in China A-Shares could be attributable to lack of transparency, weaker corporate access, language barriers and poor accounting practices, all representing characteristics of an inefficient market which can be exploited through deep research by sophisticated investors to drive alpha generation. To overcome some of those obstacles, active managers are hiring Mandarin speaking analysts and undertaking frequent company visitations to narrow the information gap that prevails within the China A-Shares universe.

To summarize, despite similar analyst coverage for China A-Shares compared to other markets, the greater number of earnings surprises accompanied by a greater magnitude of surprises suggest the A-Shares market is highly inefficient providing a greater opportunity for alpha generation through fundamental bottom-up research.

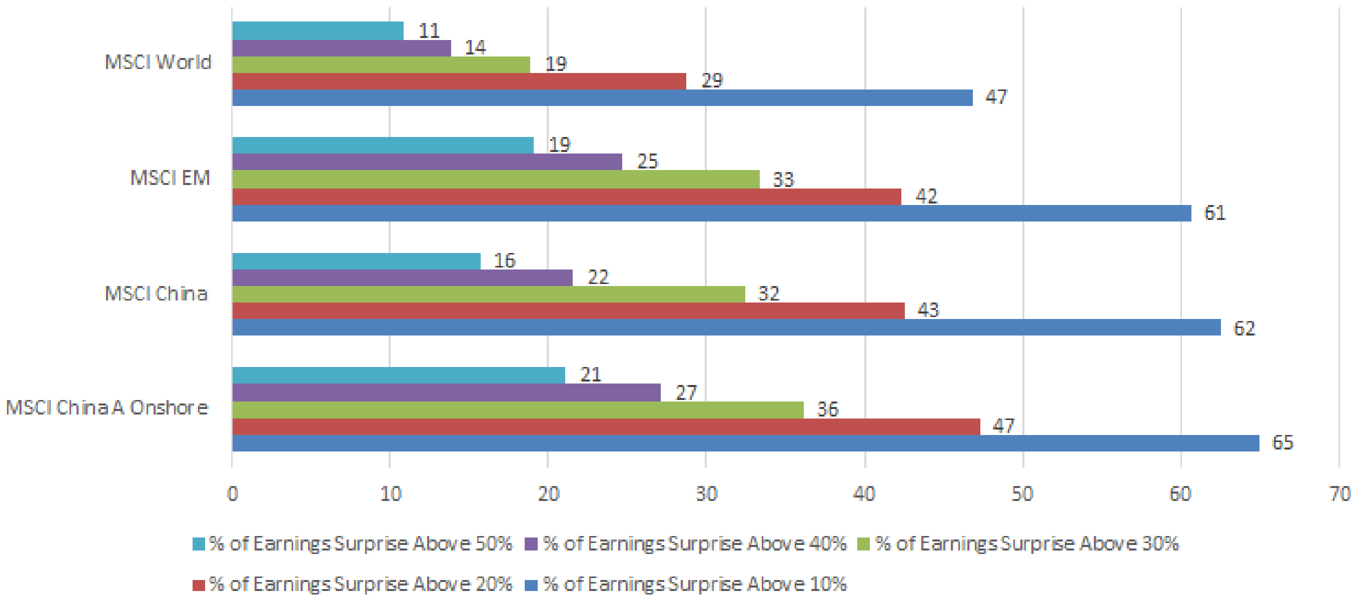
[13]Rayliant. *"Searching for the Smart Money in China A-Shares."* January 2020.

Chart 15: Analyst coverage and EPS surprise



Source: Bloomberg, Frontier. Data as at January 2020

Chart 16: Earnings surprise spectrum in %



Source: Bloomberg, Frontier. Data as at January 2020

How to approach China A-Shares?

While it has historically been okay for Australian institutional investors to largely ignore the China A-Shares market, we think that is a less justifiable stance going forward. Firstly, China A-Shares will increasingly become part of the institutional investor's universe given improved accessibility and will increasingly be represented in the typical MSCI indexes used. Secondly, China A-Shares appear an attractive investment opportunity and Australian institutional investors have scope to improve returns with greater China A-Share investment in the future.

With the improved accessibility and institutionalisation of China's domestic equities markets, Chinese equities are growing in importance along with the growing role that China plays in the global economy. In fact, the IMF estimates China's contribution to Global GDP growth to reach 28% by 2024, compared to 9% for the US[14].

Frontier expects clients' exposure to Chinese equities and to China A-Shares in particular to continue to grow in the medium to long-term in tandem with the continuous weight increase of A-Shares into global indices with China equities (in aggregate considering all types of securities) likely making up 40% of MSCI EM at 100% China A-Share inclusion factor.

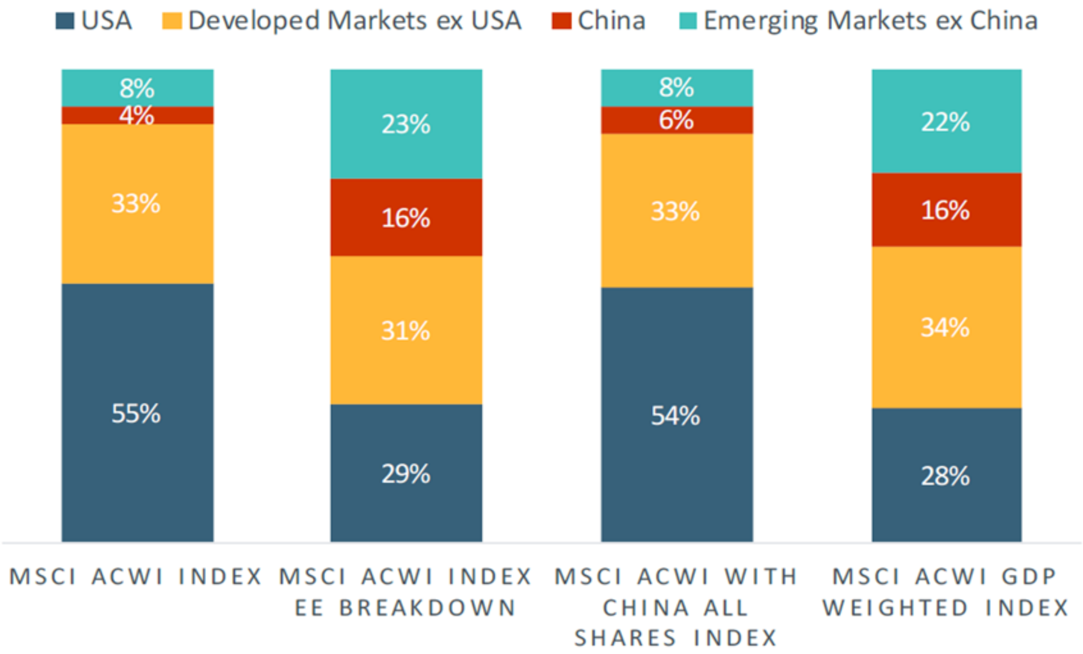
This implies that a deeper holistic understanding of China's role in equity allocation is essential in shaping investors' equity strategies.

Asset owners need to think about the ramifications of the growing influence of China and the increasing weight of China A-Shares when formulating the strategy for their overall equities position regardless of how they choose to integrate Chinese equities within their portfolios. Typically, investors resort to cap-weighted benchmarks as the neutral starting point for capital allocation. Another methodology that is less commonly used is by allocating capital to markets based on their contribution to the overall economy[15]. Under both scenarios, Chinese domestic equities' representation in global portfolios is expected to increase over time.

As observed in charts 17 and 18, China's weight in global indices would have been higher if it were to be based on the MSCI Economic Exposure methodology, which seeks to estimate a company's economic exposure based on the geographic distribution of its revenues regardless of where it is domiciled. Moreover, China's weight in global indices would be higher if it were based on its GDP contribution.

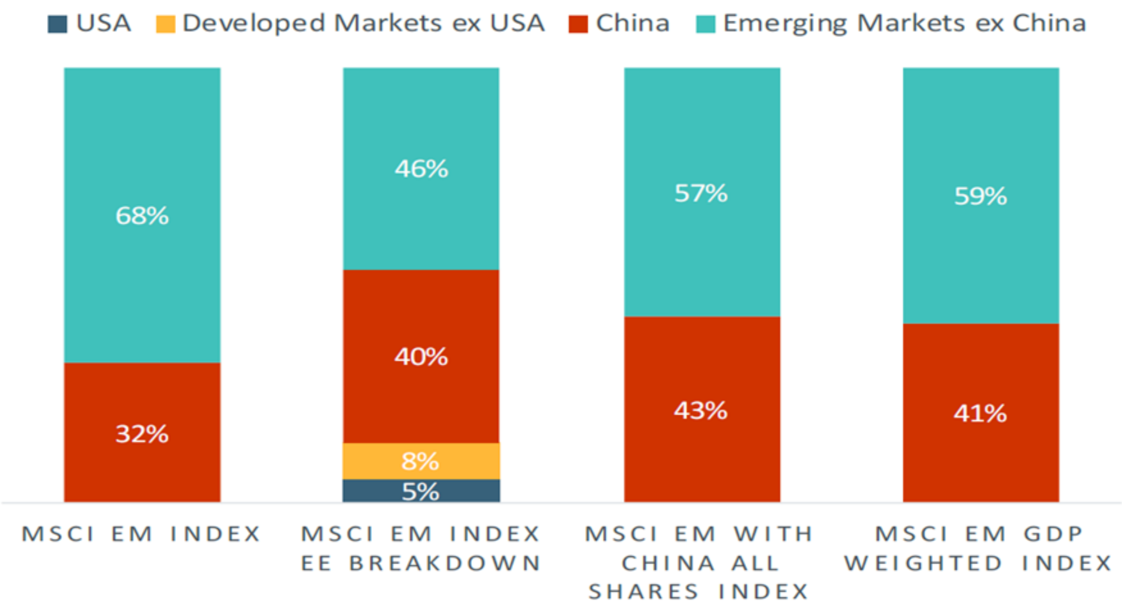
[14] Kreppmeier, Lea and Ankel, Sophia. *"These 8 Countries Will Dominate Global Growth in 2024, says IMF."* Business Insider Deutschland. 31 October 2019. "
[15] Wei, Zhen. *"China and the Future of Equity Allocations."* MSCI. June 2019

Chart 17: China's Weight in MSCI ACWI Index



Source: MSCI. Data as of Feb 28, 2019. The MSCI ACWI Index EE Breakdown (Economic Exposure) is based on the MSCI Economic Exposure Security Data module.

Chart 18: China's weight in MSCI EM Index



Source: MSCI. Data as of Feb 28, 2019. The MSCI EM Index EE Breakdown (Economic Exposure) is based on the MSCI Economic Exposure Security Data module.

Frontier's approach

When considering an allocation to China A-Shares, investors are faced with many implementation decisions that range from what benchmark to use to which type of manager to allocate that investment to. Below, Frontier outlines and provides guidance on the possible approaches for Australian institutional investors looking to invest in China A-Shares.

- **Active vs. Passive Management:** While a passive investment approach offers a low-cost way to gain exposure to China A-Shares, Frontier generally recommends investors adopt an active management approach. This reflects the high level of market inefficiencies which creates additional return potential, but also the ability to avoid companies with poor corporate governance (a feature generally more common in A-Shares companies versus developed market companies).
- **MSCI ACWI vs. MSCI EM**: Clients could invest with managers who cover the China A-Shares market within their global or EM strategies. However, not all global and EM managers allocate to A-Shares, and when they do, often these allocations are small and do not include mid- and small-cap China A-Shares. **Manager selection is key.** We generally do not see a significant number of ACWI managers allocating to China A-Shares and therefore, do not view this as a suitable implementation method. We see selective EM managers already covering China A-Shares well, while others are allocating more resources and should be better placed to invest more deeply in China A-Shares in future. **Where there is demonstrable capability and a willingness to invest in this market, investing in EM managers is our preferred approach to gain exposure to China A-Shares**.
- **Frontier is supportive of an additional allocation towards a dedicated China A-Shares strategy in specific circumstances:** The idea of managing China A-Shares separately through dedicated China managers is supported by Frontier as a "completion strategy" (i.e. where a client is "under-allocated" to China equities via its EM managers). Such an allocation would not be appropriate for all clients, given the underlying complexities and governance issues associated with China A-Shares (requiring a heightened level of due diligence and ongoing monitoring).
- **Frontier generally prefers non-onshore managers when it comes to the implementation of dedicated China A-Shares strategies.** Non-local asset managers are likely to have a better appreciation of the Australian context for institutional asset owners, be better equipped for the type of information and engagement sought by asset owners and adhere to a long-term buy and hold strategy unlike the high trading momentum-driven approach that is more common amongst domestic Chinese managers. We consider this approach more suited to Australian institutional investors given its alignment with other investment approaches and our expectation is that clients will in general access both higher governance standards and potentially better legal protections. We are confident that non-onshore managers are more likely to adhere to higher ESG standards and avoid investing in stocks with poor governance. While we do not yet have evidence that this is the best approach for generating the highest outperformance (versus high trading onshore approaches), we believe this is the most appropriate approach for Australian investors today.

The final word...

China A-Shares are now more accessible than ever before, and this paper has addressed the history and reasons why China A-Shares matter more for Australian institutional investors than ever before. China A-Shares now represent an opportunity for Australian institutional investors of all sizes and each client should consider how they are gaining exposure to this market over time.

Frontier expects clients' exposure to Chinese equities and to China A-Shares in particular to continue to grow in the medium to long-term in tandem with the continuous weight increase of A-Shares into global indices with China equities potentially making up 40% of MSCI EM when China A-Shares reach a 100% inclusion factor.

The unique characteristics of the China A-Shares market, particularly in relation to retail dominance and the associated behavioural biases and high volatility, makes it a potentially fertile ground for alpha harvesting through active management as rigorous fundamental research should be rewarded. We have discussed the various approaches to gain access to China A-Shares, noting our preference for access via EM managers with demonstrable capability and willingness to invest in this market. However, we acknowledge that a small group of clients, mostly likely large clients, may see a dedicated China A share manager appointment as a possibility to gain additional exposure to domestic Chinese equities.

Other references

Wei, Sun. "*All Roads Lead to China – An Analysis of the Access Channels to Chinese Capital Market.*" September 2019.

"*Further Weight Increase of China A-Shares in MSCI Indexes.*" MSCI. February 2019.

Wang, Xiaoshu, Hu, Jingmin, and Chen, Gongyu. "*China Through an ESG Lens.*" MSCI. September 2019