RBC BlueBay
Asset Management

Celebrating 5 years of the RBC China Equity Strategy

For professional investors only | Marketing communication

Asian Equity team

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"As the world's second largest economy and the biggest contributor to global growth, China's equity market provides investors with access to an enormous opportunity set."

The RBC China Equity Strategy (the "Strategy") has marked five years since its inception in November 2018. Over this time, the Strategy has outperformed both its primary benchmark, the MSCI China Index, and its secondary benchmark, the MSCI China All Shares Index, demonstrating a strong track record supported by the RBC Asian Equity team's robust and consistent investment philosophy and process.

A compelling long-term opportunity

As the world's second largest economy and the biggest contributor to global growth, China's equity market provides investors with access to an enormous opportunity set. Even against a backdrop of a property crisis, geopolitical tensions and weakened domestic consumption, China's economy is predicted to achieve 5.0% growth in 2023, with projections in the realm of 4-4.5% for 2024 – amongst the fastest-growing economies globally[1].

The market simultaneously offers compelling diversification benefits; China is less correlated with other global equity indices and Chinese equities appear to be less driven by global macroeconomic factors. Over a five-year period versus the MSCI World Index, the S&P 500 Index has a 98% correlation, the MSCI Emerging Markets Index 74%, and the MSCI China Index 50%[2]. The MSCI China All Shares Index, which captures full onshore / A-share exposure, demonstrates lower correlation still.

In spite of these long-term trends and benefits, China's equity market remains under-owned and under-valued. Towards the end of 2023, multiples had fallen to one standard deviation below their 15-year average, and foreign ownership of China's A-share market remained well below 5% of total market cap[3]. Moreover, whilst the MSCI has been including A-shares in its Emerging Markets Index since 2017, this continues to be on a partial inclusion basis, meaning that the typical China index or exchange-traded fund (ETF) carries a significant underweight to China's economic reality.

[1] International Monetary Fund, October 2023.
[2] UBS Quantitative Research, Wind, as at 22 August 2023.
[3] UBS Quantitative Research, People's Bank of China, Wind, as at 31 July 2023.

Capturing alpha through active investing

China's market depth (with a listed universe that now exceeds that of the U.S.) and high dispersion of stock returns over the medium to long term mean that opportunities to unearth alpha are plentiful for stock pickers in the region[4]. The market (particularly the A-share market) remains under-researched, and, whilst coverage is improving, continues to offer an enormous opportunity set for active managers.

Here we highlight why allocating capital to China's A-share market deserves careful consideration by global investors: A spotlight on A-shares. Unlike passive strategies, as active investors we are able to provide selective exposure to the asset class in structurally-winning industries and companies, and over the last five years, the Strategy has delivered an annualised return of 3.6% (an outperformance of 7.1% versus its primary benchmark)[5] (Figure 1).

Figure 1: Our strong upside capture and disciplined approach to risk stand out against China fund peers

Over last five years	Returns	Rank	Standard deviation	Rank	Sharpe ratio[1]	Rank	Tracking error[2]	Rank	Information ratio[2]	Rank	Upside market ratio[2]	Rank	Downside market capture[2]	Rank
RBC China Equity	3.61	35	23.69	56	0.07	35	7.73	68	0.93	4	100.12	27	86.08	53
MSCI China-ND	-3.54	92	26.70	12	-0.20	90	0.00	100	–	–	100.00	28	100.00	9
MSCI China All Shares-ND	-0.58	67	23.26	66	-0.10	68	6.26	87	0.47	49	92.21	47	90.52	32

Past performance is not indicative of future results and is calculated in USD. Returns may increase or decrease as a result of currency fluctuations. Last 5 years through to 30.11.2023. Created on 10.01.2024 from a universe of 160. [1]FTSE 3-Month T-Bill; [2]MSCI China-ND. Returns are presented gross of management fees and include the reinvestment of all income. The net dividend (ND) index is calculated with net dividend reinvestment.

[4] UBS Research, Wind, ADVFN.com, New York Stock Exchange.
[5] RBC GAM, as at 30 November 2023.

In contrast, passively-managed ETFs pose the risk of leaving alpha on the table, whilst tracking differences (incurred by trading costs, timing issues and total expense ratios, amongst other things) mean that they also do not capture beta as efficiently. Figure 2 demonstrates the dispersion between an ETF and the index that occurs over time.

Figure 2: Passive solutions to China not only miss out on alpha, but even lag behind the index over time

Source: Bloomberg, as at 15 January 2024.

Disciplined investment approach, 'on-the-ground' advantage, and industry expertise

Navigating China's equity markets can be a complex process, but we believe our fundamentals-driven, high conviction approach lends itself to long-term success. Holistic due diligence forms a key part of our process, supported by frequent trips, in-person meetings and site visits, as well as speaking with customers, suppliers, competitors, employees and conducting channel checks. Combined, these help us to better assess management, businesses, and industries.

> "Sector-level industry expertise allows for a clearer understanding of ESG materiality and the business model."

This first-hand research is conducted by our regional sector specialists. Regional perspectives add an 'outside-in' point of view on China's dynamic changes as we view the market both in its own right, but also in the context of the broader region. Over the past five years, we have observed that leading Chinese firms also increasingly think in this way as they grow globally. In addition, sector-level industry expertise allows for a clearer understanding of ESG materiality and a lifecycle stage view of the business model, based on learnings from other parts of Asia.

In our bottom-up stock selection process, we not only analyse financials but also integrate ESG analysis. This means that the same industry expert responsible for alpha generation is also studying ESG risks and opportunities, helping us to understand each business from a long-term, broader perspective. With company ESG data still limited in China, direct engagement with businesses can provide meaningful additional insights for understanding each company's future direction and potential risks. ESG risks are considered as part of our overall risk assessment of the portfolio, and we continuously monitor climate metrics, such as overall portfolio carbon intensity, implied temperature rise and climate value-at-risk. These considerations form an important part of our investment decision-making process.

We invest in only our best ideas based on rigorous company analysis, enabling us to carefully select long-term winning businesses in China, regardless of where they are listed. Portfolio construction is supported by our dedicated portfolio engineer to balance active risk systematically across different stock specific risks, while minimising unintended factor risk and style bias to the portfolio.

As the China Strategy reaches its five-year anniversary, we also near our 10-year anniversary of investing across Pan Asia, a track record that provides us with a solid frame of reference when selecting best-in-class companies.

Why now?

Whilst China's equity market struggled in 2023, we believe that not only does the region still offer a strong long-term investment case, but its near-term risk reward looks exceptionally compelling. China's market is under-owned by foreign investors, valuations are nearing historic lows (Figure 3), and the government is set to take further action to help revive the property sector. As these elements coincide, we may see a revival in investor interest in the asset class in early 2024.

For investors concerned with issues surrounding supply chains, or moral quandaries that may come with investing in the asset class, an actively managed strategy such as ours should provide a margin of safety. We seek selective exposure to best-in-class companies that we've met and researched ourselves. Over the past five years, we have been encouraged by the growing levels of ESG awareness from Chinese corporates. Looking ahead, we will continue to have close dialogues with our investee companies to encourage better ESG disclosure and adoption of global ESG standards.

Here we look at the increasing momentum in China around ESG factors: The rise and rise of ESG. Furthermore, our Asian Equity ESG Report 2023 takes a deep dive into what ESG means to our team, its importance to our approach and how we integrate ESG factors into our investment process.

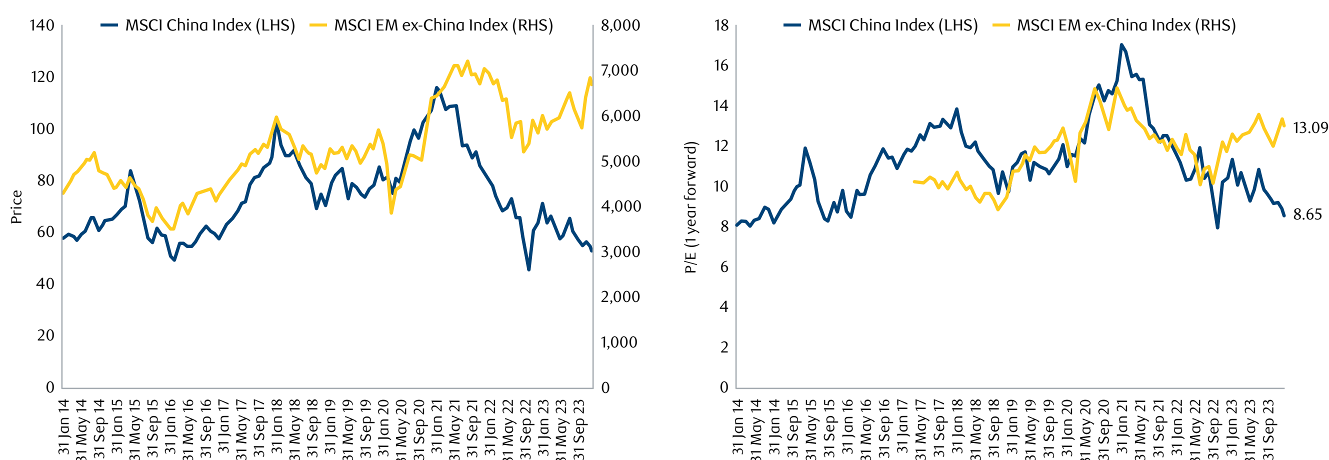
For asset allocators interested in carving China out of the broader EM equity pool, now is a good time to 'do the work'. By transitioning into a set-up where EM equity is clearly split between China and EM ex-China, asset owners can have much more flexibility to increase or decrease exposure to the region, whatever the rationale.

Other possible advantages include a China specialist that shares the same investment philosophy and clearer performance attribution by region. Even today, China is near 30% weight in the MSCI EM Index and was estimated to deliver one-third of global economic growth in 2023[6]. We believe that the asset class will continue to be an important component in the global investor's portfolio for years to come and warrants more dedicated attention.

The past five years have provided a varied and frequently surprising landscape for investors in Chinese equities. In the more recent past, the asset class has struggled on the back of the pandemic and a disappointing reopening trade. Sentiment – both domestic and international – has been weak, further fuelled by the property crisis and geopolitical tensions. Slowing global growth has also had a knock-on effect on China's economy, as it is closely tied to the health of global manufacturing and exports.

Moving into a new year, we are cautiously optimistic that things are falling into place for a rebound in China, but looking further ahead to the next five years, possible macro events such as wars, global inflation, technology disruption and numerous other factors mean that the trajectory for both China's and the global economy are hard to predict. However, in this time frame, China will continue to be a significant contributor to global growth, expected to account for 23%[7]. We believe that our focus on selecting strong, durable businesses positions us well to capture this growth and weather various market cycles, ultimately generating sustainable alpha and absolute returns over the long term.

Figure 3: Chinese stocks have never been so cheap relative to the rest of EM



Source: Bloomberg, as at 15 January 2024.

[6] IMF, April 2023.
[7] Bloomberg, using IMF WEI April 2023 forecasts.

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Siguo is a portfolio manager on the Asian Equity team at RBC GAM. She is the lead manager for the team's China strategy and is also the team's healthcare specialist. Prior to joining RBC GAM in 2017, Siguo was a sell-side equity analyst with a multinational investment bank where she specialised in China and Hong Kong consumer sectors and Hong Kong Equity strategy. She started her career in the investment industry in 2012.

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