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China is simply not worth the risk for public equity investors

By Kevin

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Institutional investors are right to worry about their exposure to China and often wrong about how they mitigate the risk, explains Christophe Roehri, deputy CEO, TOBAM.

Call it "decoupling" or "de-risking", investors are looking at China these days and rushing to the exit door. According to the WSJ, "more than $24 billion of foreign money has left China's stock market since August". Investments in emerging markets (EM) ex-China funds are one of the fastest-growing asset classes in terms of inflows.

The main US federal government pension fund just decided to exclude China's and Hong Kong's listed stocks from its benchmark index.

The trend is no surprise: China's aggressive posturing towards Taiwan, US government restrictions on the Chinese tech sector, the Chinese unsettling practice of disappearing prominent CEOs or officials for weeks at a time, raids on foreign companies and threats to their staff, poor economic performance, arbitrary state decisions that wreak havoc on markets, all of this has left foreign investors profoundly shaken.

The same investors had been drawn to China in the first place by the seductive prospects of a fast-growing economy. On that front, China delivered. In the last fifteen years, its share of global GDP has doubled to 18% today. Who has benefitted from this incredible creation of wealth? Not public equity investors. The performance of EM, including China, over the past 15 years has delivered a 3.7% annual return.

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The performance of EM ex-China over the same time period has delivered a 3.5% annualised return, meaning that the inclusion of China has only delivered 20bp of excess annualised return over the period.

Investors are absolutely right to be wary. China is a deeply autocratic country with little, if any, protection for investors. After video game editors or property developers, there is no telling which sector the authorities might next target. With the Chinese president concentrating ever more power, with no checks or balances, it’s not a matter of if but when a major crisis will take place.

Clearing a portfolio of Chinese stocks, whether they are listed in China, Hong Kong or the US, is a rational decision. But is it enough to protect investments from the looming threat of the Chinese regime?

Research shows that it is not. Crunching numbers, we made a startling finding: most of a portfolio’s exposure to China is indirect, meaning that it does not occur from Chinese stocks you may own but rather from stocks in non-Chinese companies that are heavily reliant on the Chinese market. If you want to understand what would happen to your portfolio if China decided to invade Taiwan or if its market crashed, you need to look at what happened after the Russian invasion of Ukraine.

“CHINA IS A DEEPLY AUTOCRATIC COUNTRY WITH LITTLE, IF ANY, PROTECTION FOR INVESTORS.”

According to Yale University, more than 1000 companies listed outside of Russia had to close their business operations in Russia, resulting in more than US$240 billion in losses. This is more than what the outside world owned in Russian stocks.

To effectively protect themselves from a Chinese stock market collapse, investors must scrutinise every stock in their portfolio and assess how each is exposed to China. TOBAM has developed an effective quantitative strategy to do just that and effectively manage the risk.

The risk posed by China is not unique. It is present, in fact, in every other autocratic country where arbitrariness and economic irrationality prevail. Even in the best of times, autocratic countries are economically less efficient than their democratic counterparts. They generate more instability and conflict and lack the mechanisms to resolve them. A lot of academic work asserts the link between democracy and economic performance, but it has rarely been translated into an investment strategy.

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With democracy receding around the world, displacement reaching record highs, and conflicts raging in larger numbers and with more intensity than they did twenty years ago, there is an urgency to rethink what it means to invest in autocratic countries. It means taking on an unrewarded risk and, at times, bankrolling autocrats. TOBAM’s research shows that investing in democracy offers better returns. And we are also convinced that it can improve the world.

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