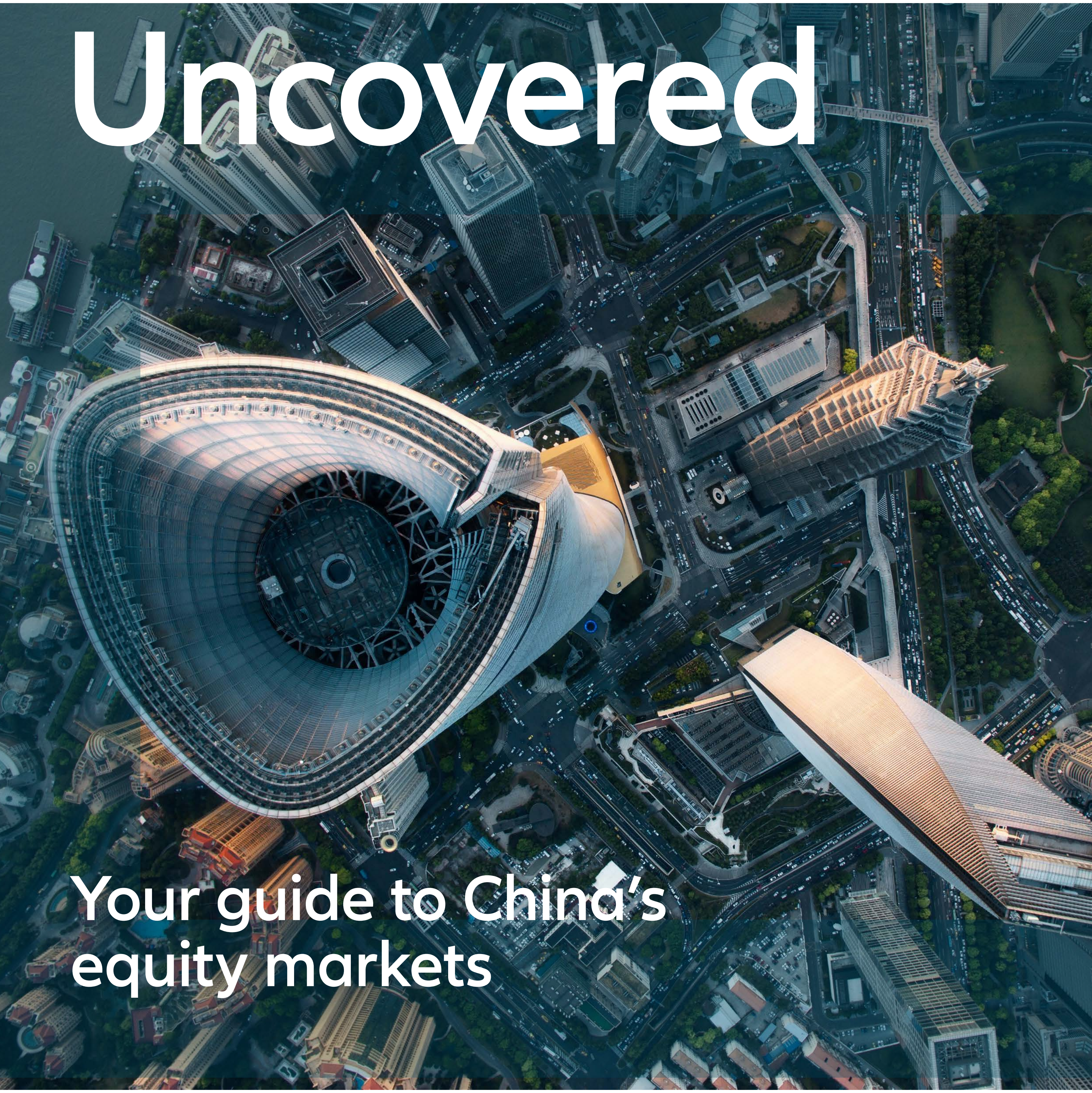
China Uncovered



Your guide to China’s equity markets

Allianz Global Investors

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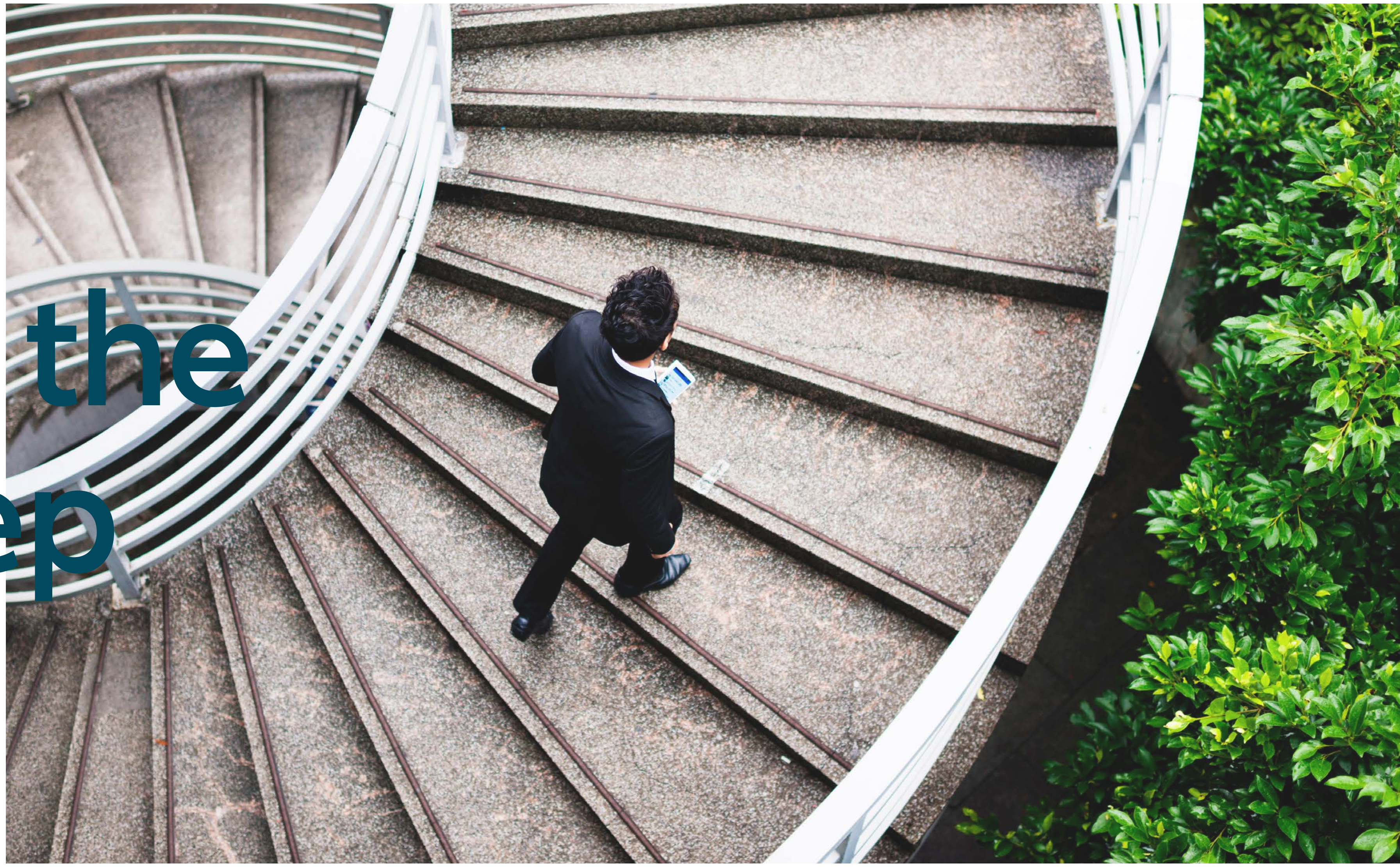
Taking the first step



> The journey of a thousand miles starts with a single step.
>
> **Lao Tzu**
> Chinese philosopher and writer
> (b. 571 BC)

China is simply too big to ignore. It contributes roughly 19% of global GDP and as an economy has proved itself worthy of the status of "major global player". China overtook Japan to become the world's second-largest economy in 2010 and is set to overtake the US economy in the coming years.

China is pursuing its own path of hybrid development following its "dual circulation" strategy which targets greater self-reliance. It aims to reduce foreign trade dependence by investing in key areas for R&D (think science, technology and healthcare) whilst promoting these capabilities globally. China is moving away from its previous image as the factory of the world. Instead it is increasingly seen as a dynamic, innovative and forward-looking economy and a global leader across a number of industries.

To achieve its growth ambitions, China will need to continue its engagement efforts with the rest of the world and also continue to open up its financial markets to global investors. China will walk a political tightrope as it balances its growing economic might with the need to collaborate with other global powers (recent efforts being demonstrated by the US-China agreement on climate change at COP26 in Glasgow in 2021).

Despite China's evolution in thinking, foreign access and economic strategy, investors continue to overlook China. Why?

Investing in China brings different risks and greater unpredictability compared to Western markets. China's capital markets, while broad and deep, remain relatively "young" with significant swings driven by investor sentiment. This short-term noise can be off-putting to investors more used to the mature institutionalised markets of the West.

Also as China grows, it needs to continue to address social concerns about inequality and tackle antitrust and intellectual property issues. All of which have stirred up recent volatility.

However, for investors **looking for attractive long-term returns**, or perhaps for **a diversifier to help lower overall portfolio risk,** China's long-term structural change and evolving markets may provide a compelling investment case – all it takes is a first step.

Why active management?

We believe China's strategic priorities for transformation will continue to translate into long-term return potential for investors. However, it is critical that investors take a long-term perspective and do not react to short-term drawdowns. When investing in China, it is essential not only to understand China's path to date but how its policy agenda is evolving.

That is why we believe **active management** is essential to navigate this market. At Allianz Global Investors we carefully select the most promising stocks based on our deep local knowledge and expertise (including our unique "boots on the ground" Grassroots Research®), bottom-up fundamental analysis and a disciplined risk management approach.

A compelling investment opportunity

Evolving financial markets with plenty of opportunity

China's capital markets have been developing with increased energy. Recognising China as an integral part of the global financial system, major equity indices have been increasing allocations to China's equity markets. However, these indices still underplay the country's significant economic potential. China's equity markets are **broad, deep, liquid and accessible.** Equities are available in a range of exchanges – from Shenzhen and Hong Kong listings to the technology-dominated STAR market.

The rise of domestic brands with significant R&D investment into key industries

Improvement in product quality is boosting the dominance of local brands. Young consumers are preferring to opt for domestic brands that appeal more to Chinese culture and style compared to western brands. Clothing, automobiles, cosmetics and tech have all proved popular. In 2010, only 10% of smartphones sold in China were domestic brands; now it's close to 90%.

China aims to be a **world leader in science and innovation** by 2050, including a number of high-tech industries such as robotics, aerospace equipment and medical devices. It is a global competitor in areas such as nuclear energy, electric vehicles, wind and solar PV. China is innovating fast: it is currently the second largest spender on research & development globally after the US.

Diversification benefits – historically low correlation to other major markets

China's equity markets are appreciated for their long-term potential for outperformance, but they're also useful as a portfolio-diversification tool. China A-shares have a correlation of 0.32 with global equities over the last 10 years, which means they move in different directions almost 70% of the time. In comparison, US and global equities have a correlation of 0.97. **Holding China's equities in a global portfolio may help generate an improved risk/return profile.**

Even adding a small amount of China A-shares to an emerging market allocation may help improve a portfolio's risk/return profile.

Historical correlation between major equity markets

	China A-shares	HK-listed China stocks	APxJ equities	GEM equities	Japan equities	US equities	European equities	World equities
China A-shares	1.00	0.61	0.48	0.45	0.24	0.29	0.28	0.32
HK-listed China stocks	0.61	1.00	0.83	0.81	0.49	0.46	0.52	0.54
APxJ equities	0.48	0.83	1.00	0.97	0.57	0.68	0.68	0.77
GEM equities	0.45	0.81	0.97	1.00	0.54	0.67	0.69	0.76
Japan equities	0.24	0.49	0.57	0.54	1.00	0.57	0.68	0.66
US equities	0.29	0.46	0.68	0.67	0.57	1.00	0.77	0.97
European equities	0.28	0.52	0.68	0.69	0.68	0.77	1.00	0.85
World equities	0.32	0.54	0.77	0.76	0.66	0.97	0.85	1.00

Source: Bloomberg, Allianz Global Investors, as of 31 December 2021. Correlation data is calculated based on historical return of respective MSCI indices for the past 10 years, using weekly US dollar return

Low correlation
High correlation

Long-term outperformance

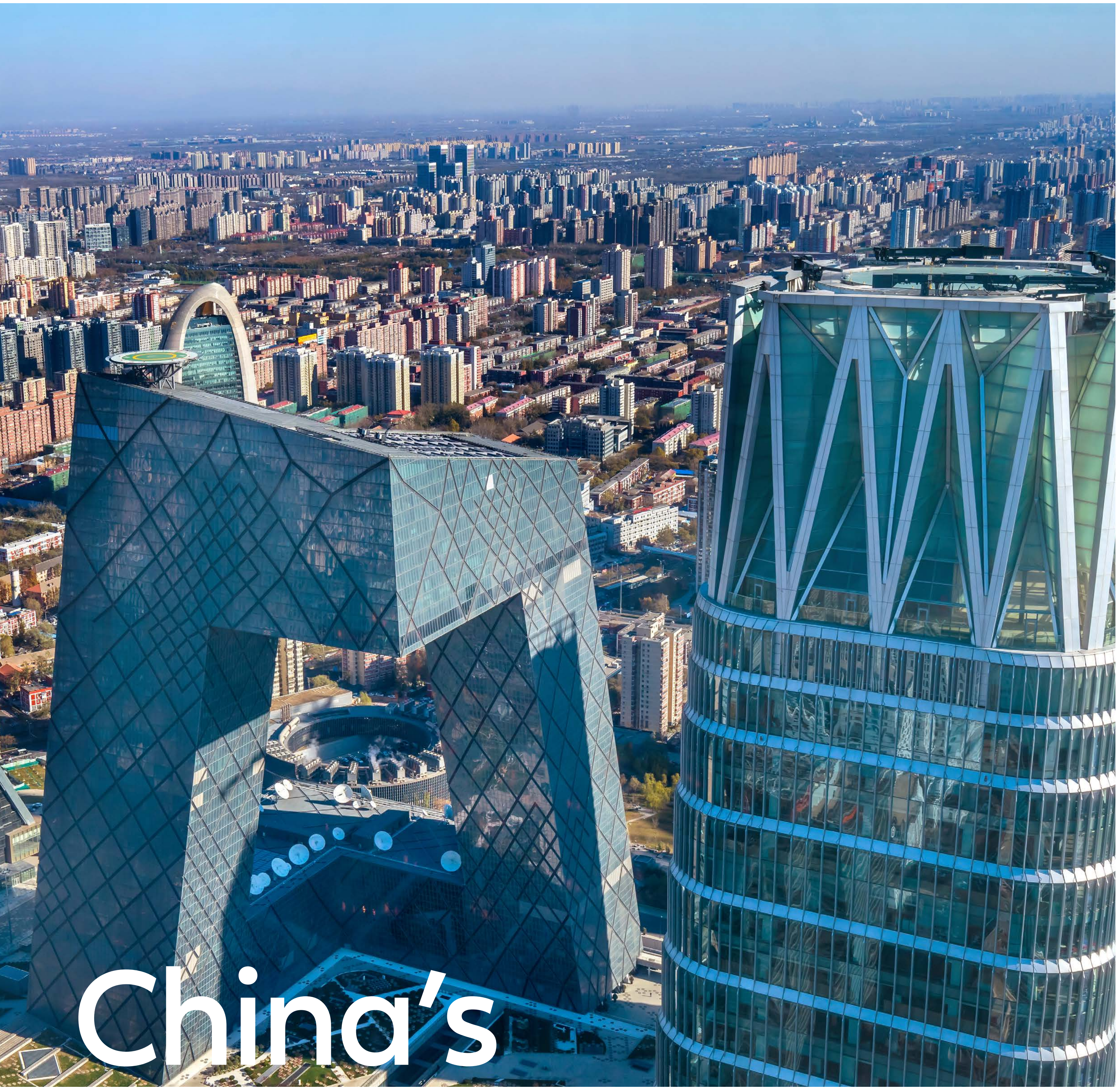
Over time, investors in China's equities have historically been rewarded with long-term outperformance. From January 2000 to the end of March 2022, the MSCI China Index total return is 249% in EUR terms or 284% in USD terms (source: Bloomberg). In the past, moments of volatility have proved to be buying opportunities for many long-term investors.

An investment in the MSCI China Index from January 2000 to the end of March 2022 would have generated a 249% (EUR terms).

249% (in EUR)

January 2000 – March 2022

Past performance does not predict future returns. Index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. It is not possible to invest directly in an index



China's transformation

We view China's transformation around three key phases:

1

Membership of the World Trade Organisation (WTO) 2001

China agreed to abide by WTO rules and committed to economic reforms, which helped the country to quickly become an essential link in the global supply chain.

2

Becoming the world's second-largest economy in 2010

By overtaking Japan, famed for its technology, China moved from being a manufacturer of cheap goods to a high-tech leader higher up the value chain. Simultaneously, China began integrating its financial markets into the global system – via its Stock Connect and Bond Connect programmes – giving foreign investors easier access to China's markets. More recently, Chinese equities have been added to some of the most prominent global stock indices, such as the MSCI, reflecting China's growing importance to the global markets.

3

China as a global leader

Poised to overtake the US as the largest economy, China must walk a tightrope as it manages its growing economic might and focuses on honing its social-equality "mandate" and soft-power skills. China's political system, combined with its domestic and global economic stature, will make this a uniquely challenging balancing act – both for itself and the world. Yet China's success in doing so will be critical to the world's stability over the next decade.

What does China's future look like?

Based on China's strategic long-term plans, we have identified a number of key themes that we believe are opportunities for investors in the medium to long term*:

- Import substitution
- New consumption
- Environmental commitment
- Digital life
- Healthcare transformation
- Frontier technology
- Quality education
- Financial inclusion
- Food security

Investments in these key themes will become the backbone of China's future growth. As an active investor we provide our partners with the expertise required to navigate this deep and broad market, led by an on-the-ground presence and thorough local knowledge.

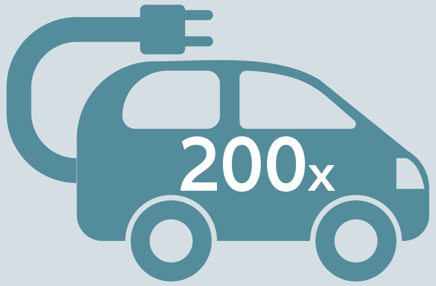
* There is no guarantee that these investment strategies and processes will be effective under all market conditions and investors should evaluate their ability to invest for a long-term based on their individual risk profile especially during periods of downturn in the market

Key investment areas "deep dive"

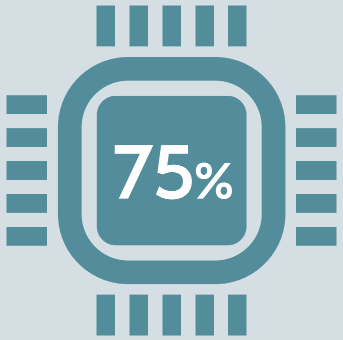
Environmental commitment

To grow, China needs energy, and a lot of it. At present, it is the largest carbon emitter globally; however, as China looks to its future, the country is driving its structural economic changes forward by gradually decarbonising high-emitting sectors. As such, China seeks to achieve carbon neutrality by 2060, with carbon emissions peaking by 2030. Did you know that the country has been the **largest investor in renewable energy** over the last decade, notably so in solar? Not only has the country become a low-cost leader in this space, but China is considered a global technology leader in all-things solar.

As China advances its green transition, substantial investments are also being made in electric vehicles, such as USD 45.3bn invested in electric transport in 2021[1], and more recently in hydrogen technology and other "clean technologies". To date, China is the largest market for electric vehicles (EVs) globally, estimated to reach 5 million EVs by 2025[2].



200x increase in fuel-cell electric vehicles by 2030[3]



Today, China is a leader in the production of polysilicon – required in the production of solar panels – responsible for over 75% of global output.[5]

Frontier technology

With China actively striving to become the world's high-tech standard-bearer, the government is pursuing major investments in areas including 5G infrastructure, digitisation, semiconductors and artificial intelligence. However, this is also driven by a strategic need for greater national self-sufficiency to achieve core technological independence by 2025.

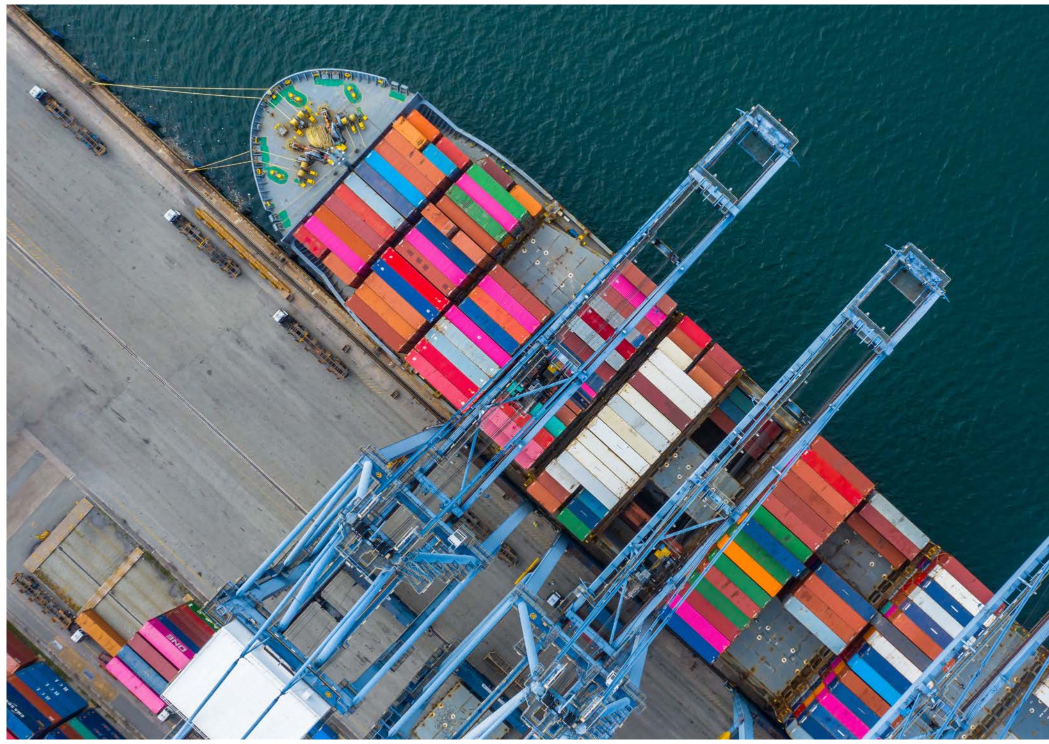
Take, for example, semiconductors: China consumes 35% of the global supply of semiconductors yet manufactures only 10%.[4] Semiconductors are in everything: 5G (where China has been a front runner on its deployment), cloud data centres, edge computing, Internet of Things (consumer and industrial), smart cities, and fully autonomous vehicles and related technologies. Becoming a leading player in semiconductor development and production will further strengthen China's technological transformation and help to overcome supply chain issues in the long run.

Sources:

1 BloombergNEF Energy Transition Investment Trends, 2021
2 JP Morgan Research as of 10 October 2018
3 Belfer Center for Science & International Affairs
4 Semiconductor Industry Association (2020)
5 China's share of world's polysilicon production grows from 30% to 80% in just one decade, Solar Power World, 27 April 2022

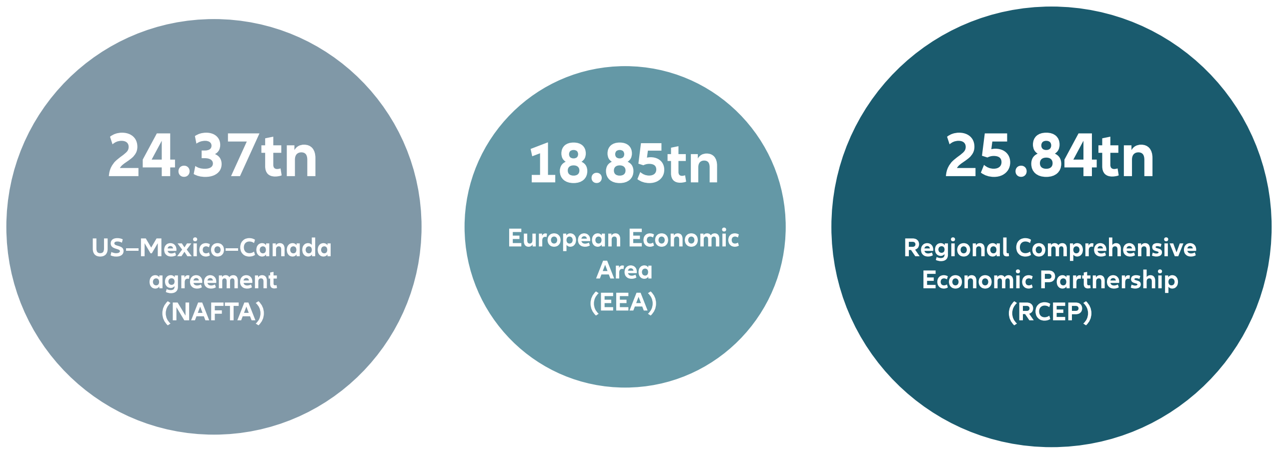
New alliances

While US-China trade tensions may continue, China is looking elsewhere to forge alliances. Take for example the free-trade **Regional Comprehensive Economic Partnership (RCEP)**, established in November 2020. It represents an economic bloc of Asia-Pacific countries that is home to around one-third of the world's population. Elsewhere, after seven years of negotiation, the EU-China **Comprehensive Investment Agreement (CAI)** was signed in December 2020.



The scale of the Asia-Pacific alliance

NAFTA vs EEA vs RCEP – Total 2019 GDP of member countries of selected regional free trade agreements (in USD)



Source: Statista, 2019

Evolving market access

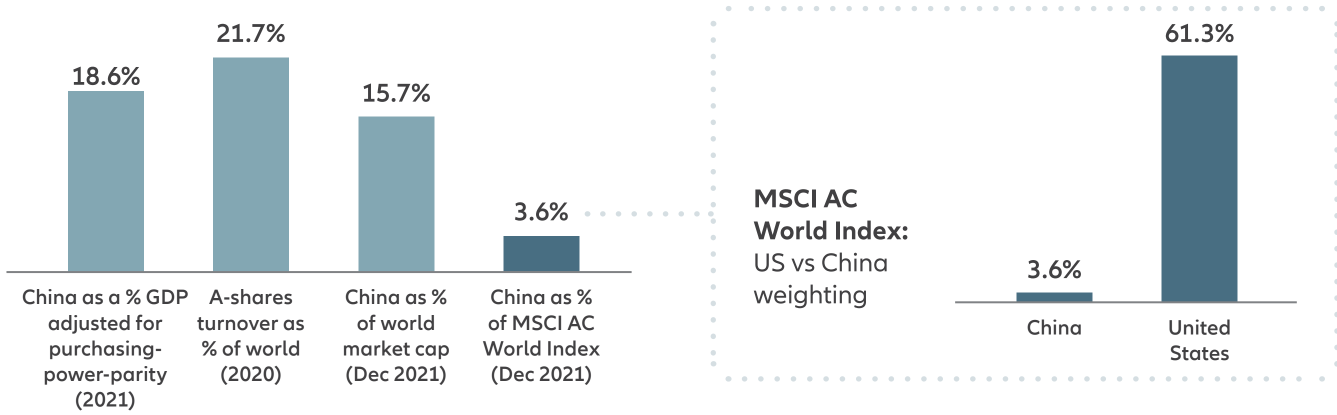
Growth potential

China accounts for roughly 19% of global GDP[6] and has **enviable structural conditions** to further fuel its growth: a growing middle class, rising disposable incomes, healthy consumer behaviour and a growing appetite for domestically produced goods and services. Government policy recognises that a vibrant private sector will continue to play a large role in China's future growth – currently representing 60% of GDP. China is changing **from imitator to innovator** with its economic growth increasingly driven by strategic investment and innovations in areas that have more potential to add value to China's economy than traditional manufacturing. Improving product quality is boosting the dominance of local brands over imported ones. In the Covid-19 pandemic's aftermath, domestic consumers are disproportionately favouring high-end Chinese brands instead of the old European favourites.

New opportunities for investors

China's capital markets have been **transforming and opening up to foreign investors** with a confident energy. As China has become established as an integral part of the global financial system, major stock indices have been increasing **allocations** to China's equity markets. However, these indices still underplay the country's significant economic potential, considering the size of its economy and markets. Investors in emerging-markets passive funds are therefore at risk of under-allocating to China's equity markets, which are broad, diversified, liquid and now more easily accessible than ever.

Key statistics on China's gross domestic product (GDP) and Chinese equities



Source: China's share of global gross domestic product (GDP) adjusted for purchasing-power-parity (PPP) from 2011 to 2021 with forecasts until 2027, Statista, 20 April 2022. FactSet, MSCI, Goldman Sachs Global Investment Research, as of 31 December 2021

Market access regulations have relaxed in recent years

2002	2011	2014	2016	2017	2018	2019	2020	2021
Qualified Foreign Institutional Investors Scheme (QFII)	RMB Qualified Foreign Institutional Investors Scheme (RQFII)	Shanghai-Hong Kong Stock Connect	CIBM Direct Shenzhen-Hong Kong Stock Connect	Bond Connect	Selected commodity futures opened to foreign investors	Shanghai-London Stock Connect China bonds' inclusion in Bloomberg Barclays	China bonds' inclusion in JPM GBI-EM	China bonds' inclusion in FTSE WGBI

Source: IPE Capital, data as of 30 September 2019. The above is for illustrative purposes only and is not a recommendation or advice to buy or sell any security. Past performance, or any prediction, projection or forecast, is not indicative of future performance

China's equity markets

Expanding equity markets with plenty of potential

Did you know that China's equity markets are larger than those of the euro area combined?

The Shenzhen, Shanghai, Hong-Kong and US-listed American Deposit Receipt (ADR) markets totalled approximately USD 17.2 trillion (and 6,215 stocks) in March 2022 versus USD 9.7 trillion (and 3,686 stocks) for the euro area.[1]

Until late 2002, foreign investors in China were denied access to the Shanghai and Shenzhen stock exchanges and could only invest in Chinese public companies from mainland China listed in the Hong Kong Special Administrative Region (H-shares). Another, more limited, option was to invest in ADRs – namely in Chinese companies registered outside China.

Through A-shares, foreign investors are now able to directly invest and participate in China's evolving growth story.

Types of Chinese equities

A-shares

A-shares are the shares of domestic/mainland companies in China. These shares are **traded on the Shanghai or Shenzhen stock exchanges.** They are traded in renminbi/yuan, the currency of the People's Republic of China.

In 2002, China A-shares first became available to foreign investors through the Qualified Foreign Institutional Investor (QFII) programme. Initially this was very restrictive. 2014 saw the launch of the Shanghai-Hong Kong Stock Connect, allowing international investors to purchase A-shares traded on the Shanghai Stock Exchange through Hong Kong-based brokers. By 2016 QFII rules were finally relaxed by China's State Administration of Foreign Exchange's (SAFE), making it less restrictive for foreign investors to participate. In December 2016, foreign investors were allowed access to the Shenzhen Stock Exchange. The introduction of the Connect programme was a significant milestone on the way to its MSCI Index inclusion.

H-shares

H-shares are shares of mainland China companies **traded on the Hong Kong Stock Exchange.** H-shares are traded in Hong Kong dollars. Companies can float their shares simultaneously on the Hong Kong market and one of the two mainland Chinese stock exchanges in Shanghai or Shenzhen.

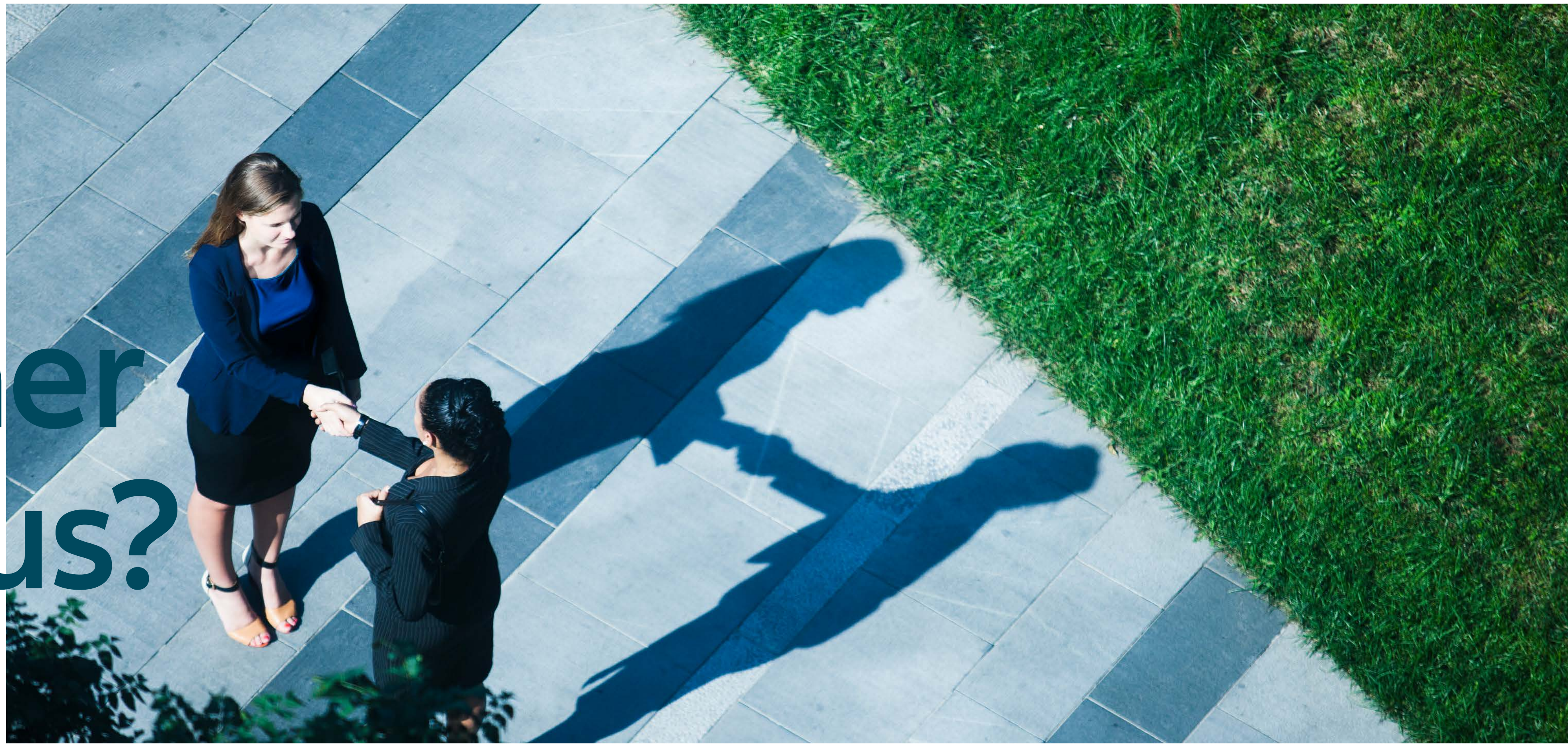
ADRs

American Depositary Receipts, or **ADRs**, refer to certificates issued by US banks representing shares in foreign companies and **traded on US stock exchanges.** An ADR may relate to one, several or even a fraction of a share. ADRs and their dividends are settled in US dollars. ADRs provide US and other global investors with an easy and liquid way to own foreign stocks. However, Beijing's long-term plan is to encourage companies to list in Hong Kong or other domestic markets and discourage listing on US exchanges via ADRs.

Source:

[1] Shenzhen Stock Exchange, Shanghai Stock Exchange, Hong Kong Stock Exchange, Bloomberg, Allianz Global Investors, as of 31 March 2021. The total figures are for comparison only, the stocks included may be listed in more than one exchange. Offshore China stocks are defined based on companies with ultimate parent domiciled in China. Suspended stocks, investment funds and unit trusts are excluded

Why partner with us?



Opportunities in China and across Asia are expanding in line with the rapid growth and transformation of this dynamic region. However, investing in China's broad markets requires an experienced team with deep local knowledge and a keen understanding of China's complex landscape, to manage excessive risks and to actively exploit the opportunities as they arise.

At Allianz Global Investors, we proudly enjoy a strong local presence across Asia Pacific, with 128 investment specialists located across five regional offices. This allows us to:

1) Respond effectively to changing markets. Our active management skills help identify promising firms and avoid weaker businesses

- **Understanding cyclical effects**: our active approach can be invaluable in recognising and understanding inflection points in economic cycles
- **Taking a long-term view**: active strategies can take a longer-term view and align with the trends reshaping markets
- **Actively engaging with companies**: improving transparency and creating change
- **Focus on innovation**: pushing the boundaries of investing to unlock new sources of return

2) Actively pursue an ESG risk assessment approach

- Proprietary ESG risk signals, portfolio managers and fundamental analysts
- Active analysis of ESG-related tail risks

3) Routinely gather and gain vital local insights from between 1,000 to 1,500 yearly company meetings, factory visits and field trips to investee companies by our AllianzGI China equity team

4) Capitalise on our proprietary research collaboration platform, Grassroots Research®, to test and to share investment research globally.

Our first equity strategy in the region launched in 1985

Hong Kong

No. of IP: 59
- Regional & single country equities
- Balanced/multi asset strategies
- HKD fixed income

Singapore

No. of IP: 24
- Asia fixed income
- Asia Pacific REITs
- Alternatives
- RMB fixed income

Japan

No. of IP: 11
- Japan equities
- Multi asset

Taiwan

No. of IP: 30
- Local equities
- Fund of funds
- TWD fixed income

Shanghai

No. of IP: 3
- Local multi asset

Indonesia

No. of IP: 8
- Local equities
- IDR fixed income

IP= Investment Professionals. Source: Allianz Global Investors as of 31 March 2022. * Through predecessor companies

Allianz Global Investors at a glance

24
locations

716
investment professionals

EUR 637bn
AUM

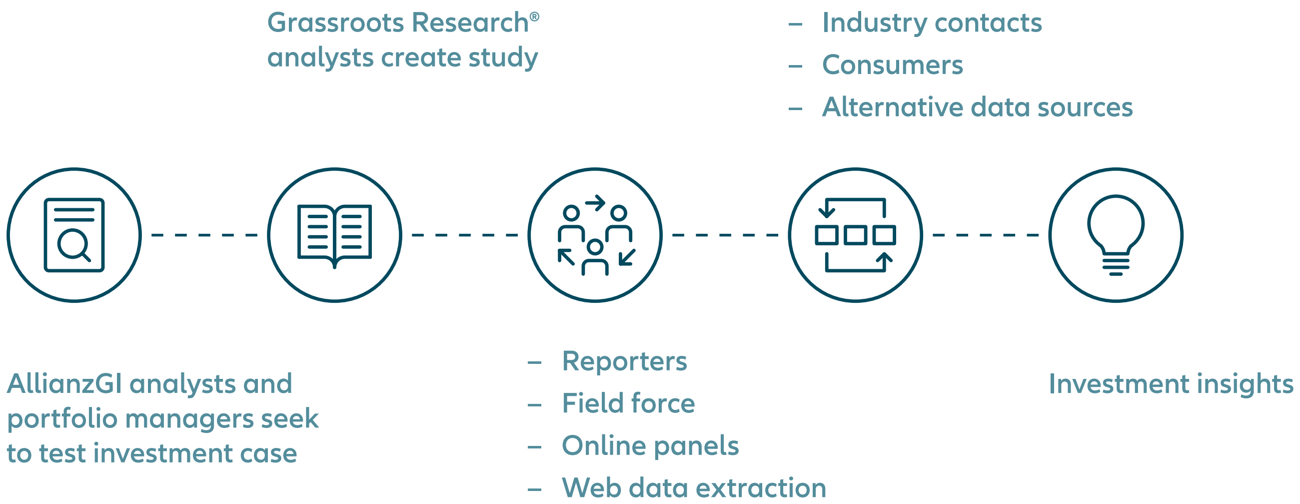
Source: Allianz Global Investors as at 31 March 2022

Grassroots Research®

Generating valuable local insights

Allianz Global Investors' proprietary investigative research division, Grassroots Research®, generates in-house insights on key stocks and industry drivers in collaboration with our portfolio managers and research analysts, seeking to identify inflection points in business trends.

- Utilises local expertise of about 25 independent journalists and 137 investigators to interview sources across Asia Pacific
- Produces approximately 100 Asian-focused studies a year
- Leverages technological tools to target thousands of consumers and businesses online
- Mines and analyses unstructured data from multiple alternative sources, including social media and other public sources



Source: Allianz Global Investors as of 31 December 2021. Grassroots Research® is a division of Allianz Global Investors that commissions investigative market research for asset-management professionals. Research data used to generate Grassroots Research® reports are received from independent, third-party contractors who supply research that, as far as permissible by applicable laws and regulations, may be paid for by commissions generated by trades executed on behalf of clients

For more information about investing in China, please contact your local representative or visit:

https://sg.allianzgi.com/china