

Fourth Quarter 2020

THE ABCs OF CHINA A-SHARES

INTRODUCTION

MSCI added China's mainland equity market — China's A-shares* — to the MSCI Emerging Market Index (MSCI EM) in 2018 and 2019, which is expected to increase access to and investment in domestic Chinese markets and further strengthen the nation's relevance in the global equity markets.

- The increased relevance is expected to have a dramatic impact on performance, benchmarking, and portfolio exposures in the global markets.
- Over the long term, investors may find managers adding Chinese exposure to portfolios and potentially more dedicated total China and A-share specific funds available to investors.
- In China:
 - Retail investors dominate this inefficient market.
 - The liquid market contains thousands of stocks and a market capitalization greater than many developed markets, but full integration will take several years.
 - Exposures of the local market are much different than offshore listed Chinese equities.
- China is a highly volatile market and investors should be vigilant of the ever-present geopolitical and investing risks of the Chinese market.

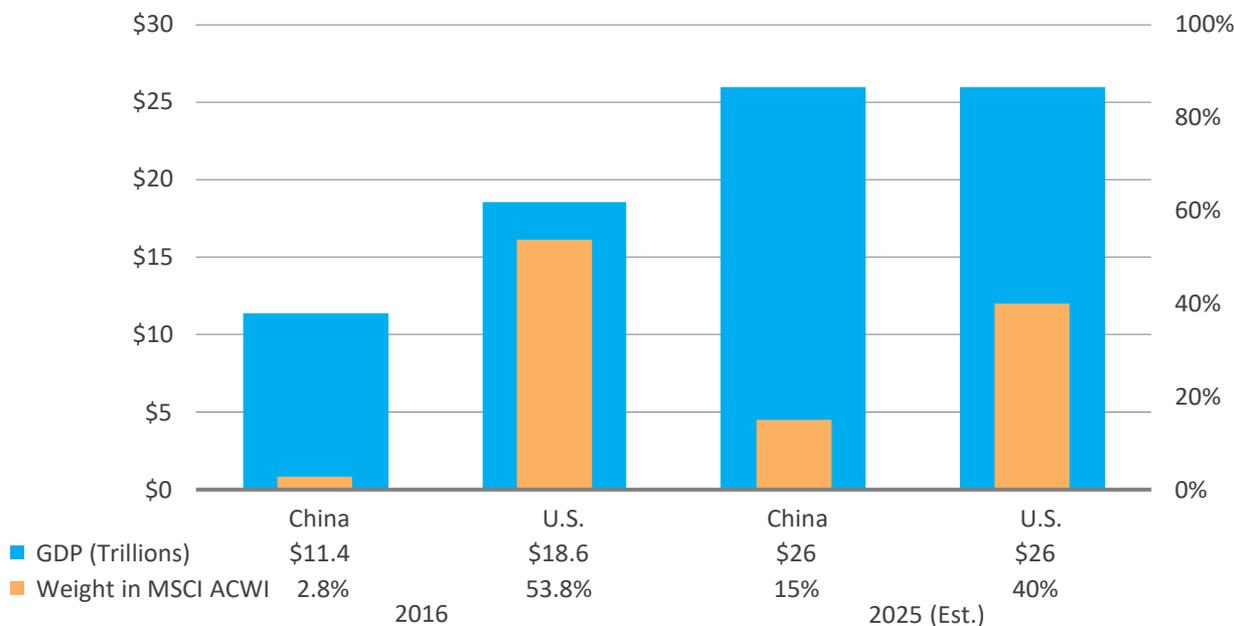
*A-shares are equity shares traded in mainland China. Other shares, such as H-shares, traded in Hong Kong and ADRs (American Depositary Receipts) traded in the U.S., are traded outside of mainland China. Additionally, other index changes beyond the inclusion of A-shares were reclassifications of Argentina and Saudi Arabia from Frontier to Emerging Markets and are highlighted in the Appendix.

A-SHARES INCLUSION

CHINA'S EQUITY MARKETS AND ECONOMY

- The opening of China's A-share market and inclusion in indices cannot be ignored because of the country's existing and ever-growing global importance.
- China is one of the largest and fastest growing economies and is estimated to be as large as the United States by the middle of this decade, yet the country's representation in global equity indices remains small.

GROWTH IN U.S.' AND CHINA'S MARKETS AND GDP
 Projected Weight in MSCI ACWI Index and GDP – 2025

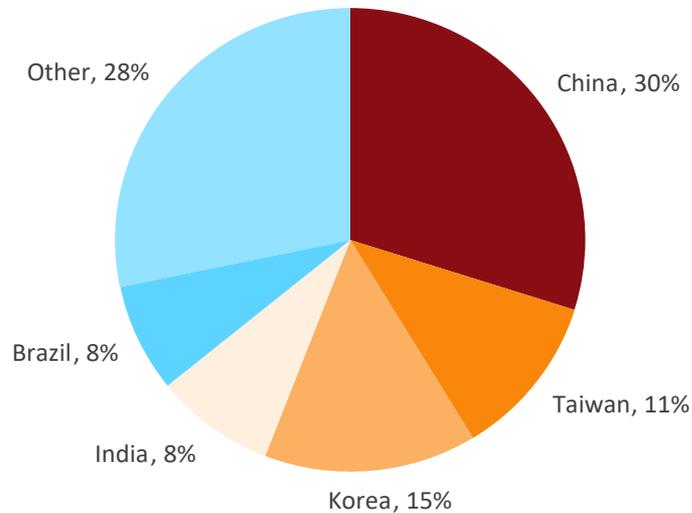


Data Source: Acadian, as of September 30, 2020

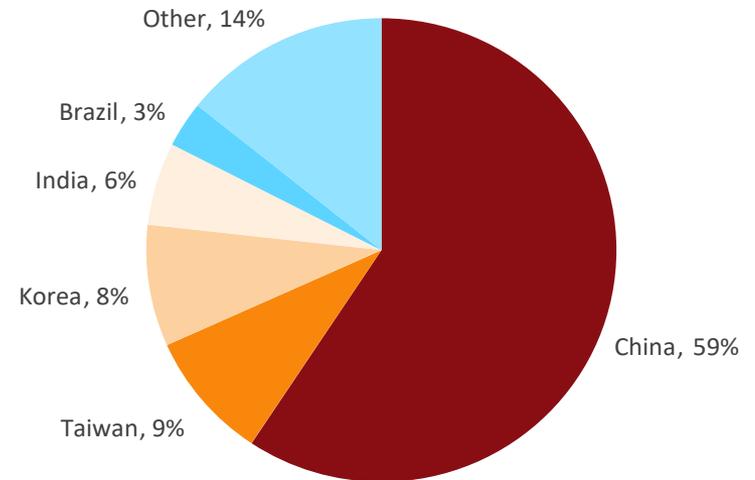
IMPACT OF MSCI INCLUSION

- The initial inclusion of A-shares was small and had a minimal impact on the MSCI EM Index.
- China's total portion of the MSCI EM Index has reached nearly 60% with the inclusion of A-shares, as of September 30, 2020.
- Asia comprises nearly 80% of the MSCI EM + China A Index.

MSCI EM Index
March 31, 2018



MSCI EM + China A Index
September 30, 2020



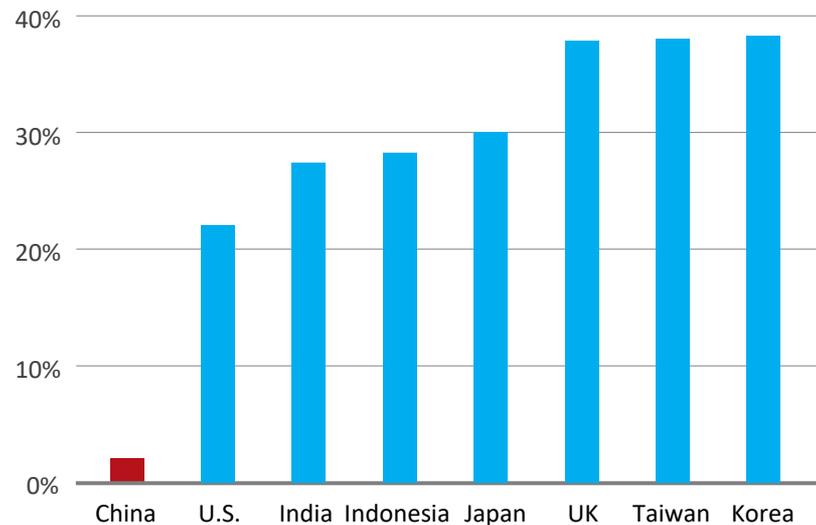
Data Source: MSCI

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FOREIGN OWNERSHIP IS LIMITED

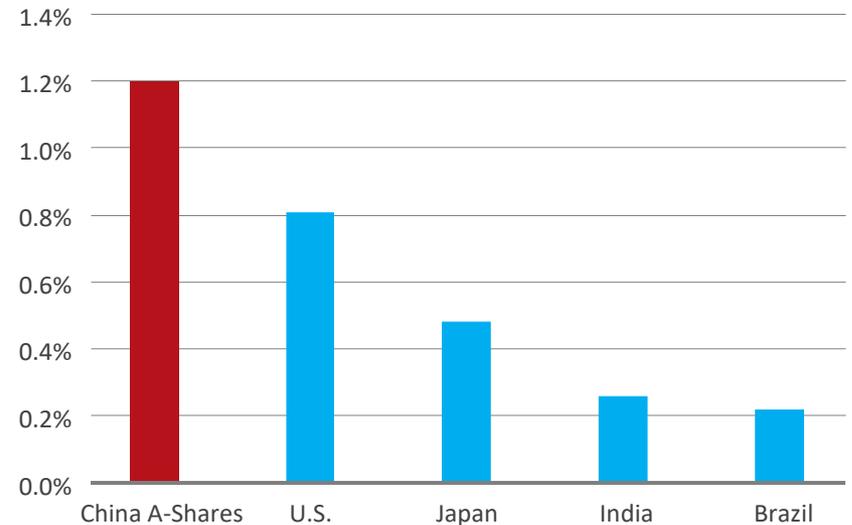
- Foreign public equity investment in China is a small fraction of the foreign ownership in the Asian emerging markets of South Korea and Taiwan.
- Trading in A-shares has been dominated by local retail investors, which has provided a large and liquid, yet volatile, market despite a lack of foreign investors.

A-Share Foreign Ownership, the Lowest Among Major Markets



Data Source: Bank of America Merrill Lynch, as of March 31, 2018.

Ratio of Average Daily Trading Volume to Market Capitalization



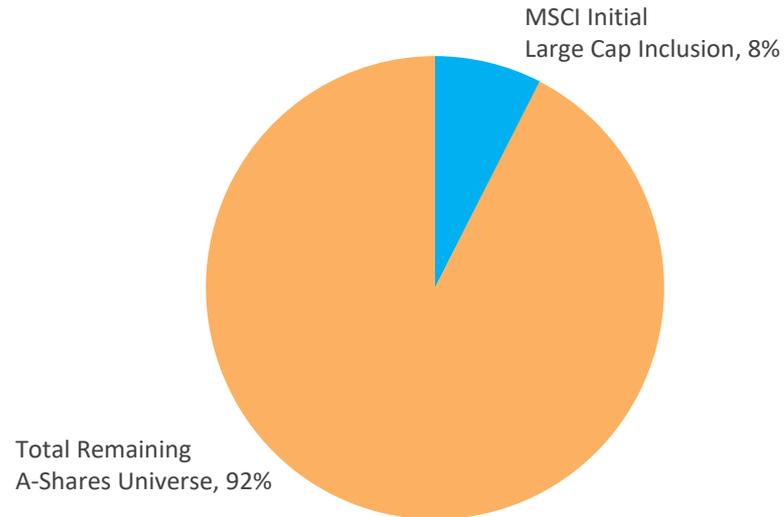
Data Source: Acadian, as of March 31, 2018

MSCI INCLUSION

The integration of China A-shares was incremental:

- The initial inclusion was approximately 230 stocks.
- Longer-term plans could further increase the integration.

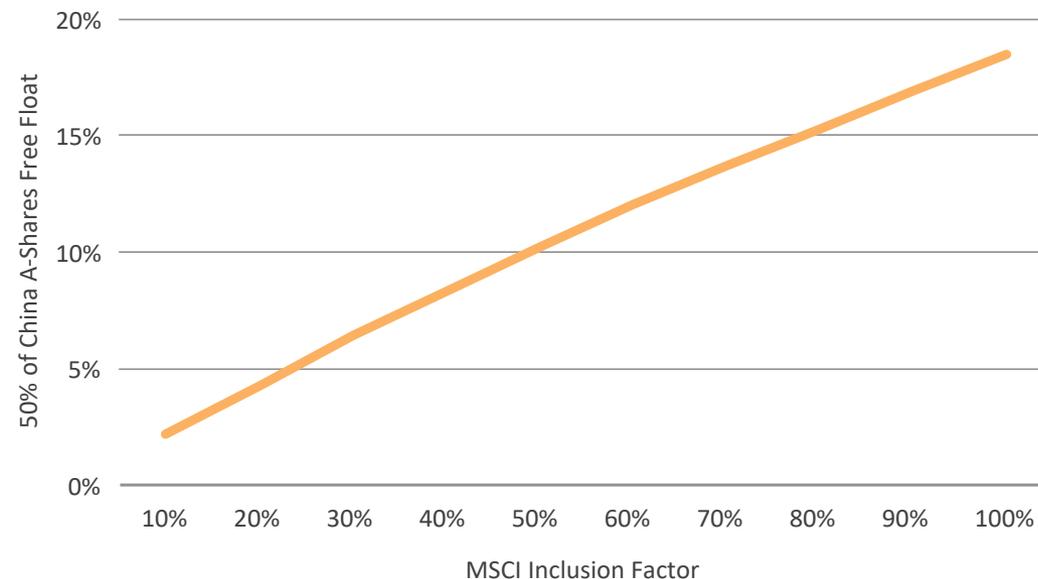
MSCI's Initial Inclusion Captures a Small Slice of China's A-Share Universe



MSCI INCLUSION: WHAT'S NEXT?

- The A-shares index allocation is likely to comprise a double-digit portion of the index in the long term, materially adding to the approximately 5% weight currently in the MSCI EM Index.
- But the inclusion of a new country in an index takes time.
 - In the 1990's, South Korea took six years and Taiwan nine years to fully integrate into the benchmark after 20% and 50% partial inclusions, respectively.

A-Shares' Weight in MSCI EM Index as MSCI Includes More A-Shares Securities



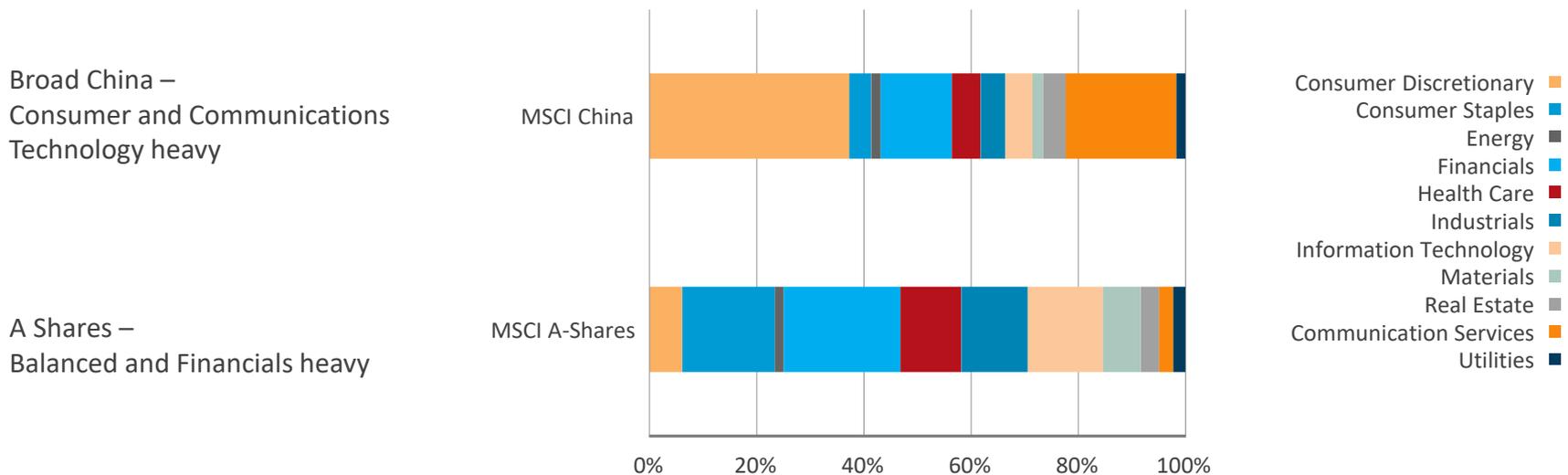
Data Source: Bank of America Merrill Lynch, assumes 50% of market free float and illustrates weight based upon MSCI's gradual inclusion of available stocks., estimate as of May 29, 2018

COMPARING CHINA'S MARKET

EXPOSURES

- Sector exposures differ materially between A-shares and the broader China index – known as MSCI China Index, which includes onshore and offshore securities trading on exchanges outside of China.
- Consumer and communications technology stocks comprise a significant portion of China’s equity market, but are a much smaller part of A-shares.

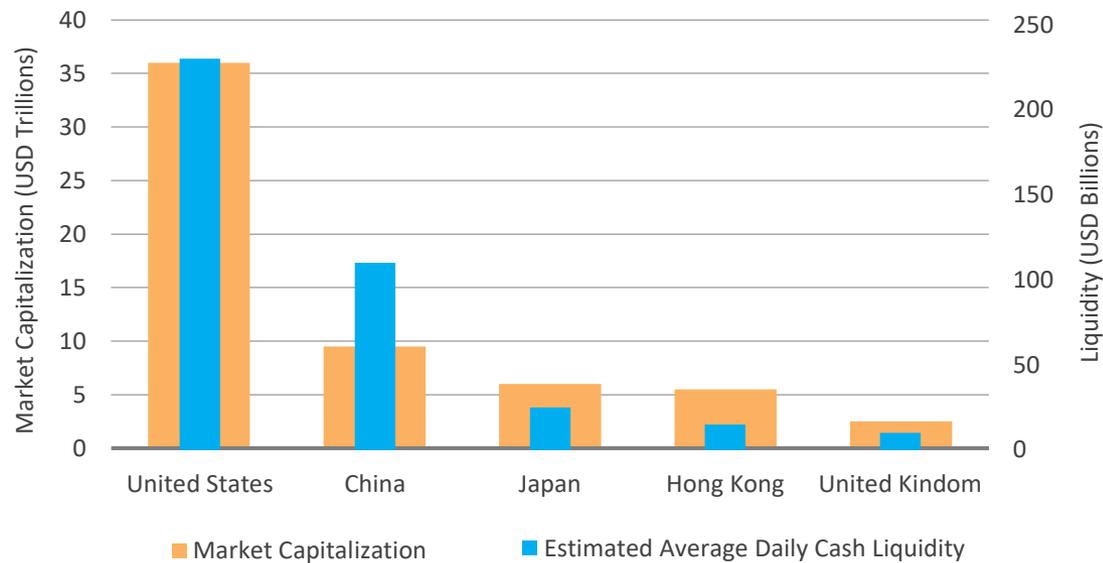
Sector Distribution for Onshore and Offshore Markets as of September 30, 2020



CHINESE EQUITY MARKETS vs. THE WORLD

- The market capitalization of China A-shares eclipses that of Japan and the United Kingdom without significant foreign investment.
- The market capitalization and number of listed securities has approximately doubled in the last 10 years.

Top Five Markets by Capitalization and Liquidity

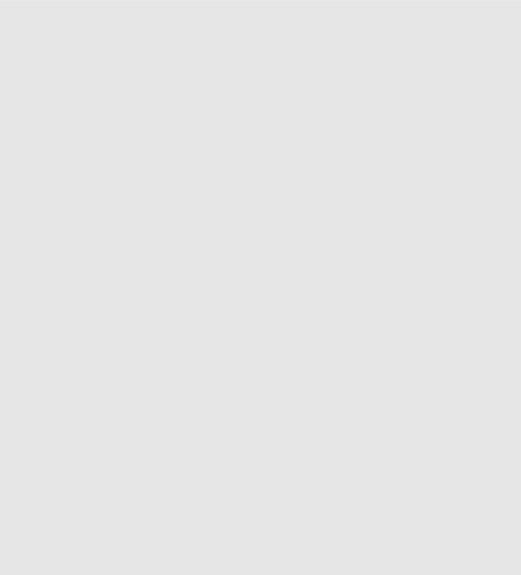


CHARACTERISTICS

- Equity investors could realize diversification benefits by investing in China's A-share market, which has exhibited lower correlation to other major equity markets than those markets to one another.

Correlations Among Equity Returns, 2001 – 2020

	China A	China H	Europe	Germany	Japan	UK	U.S.
China A	1.00						
China H	0.66	1.00					
Europe	0.36	0.66	1.00				
Germany	0.34	0.64	0.95	1.00			
Japan	0.27	0.51	0.66	0.61	1.00		
UK	0.36	0.65	0.96	0.86	0.64	1.00	
USA	0.34	0.58	0.87	0.86	0.62	0.83	1.00
Australia	0.37	0.67	0.83	0.77	0.62	0.82	0.79

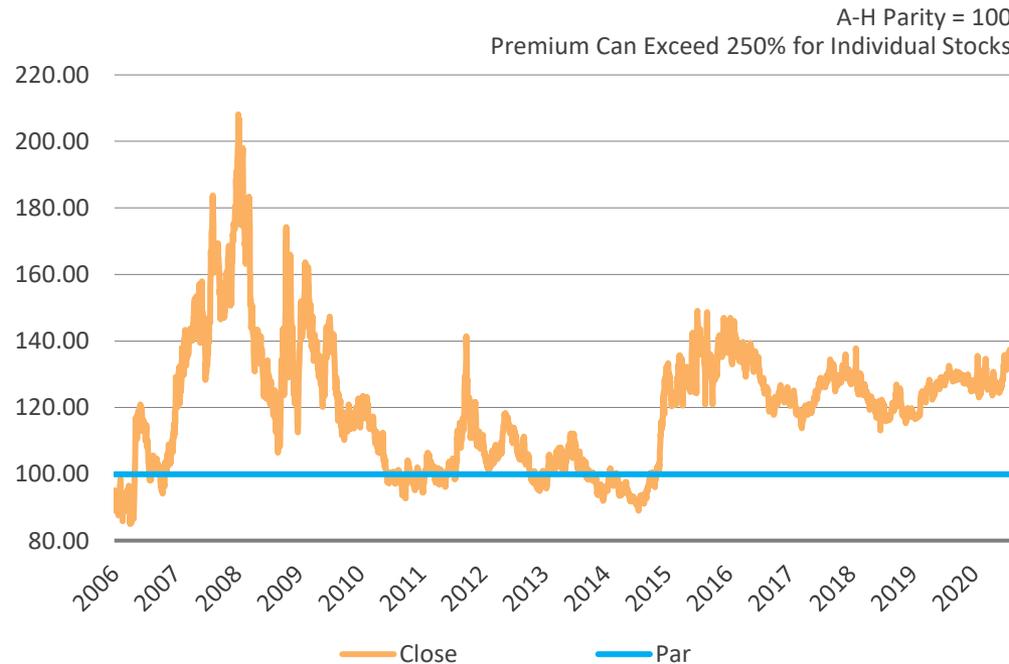


ACTIVE MANAGEMENT AND CHINA'S LOCAL MARKET

ACTIVE MANAGEMENT

- Market inefficiencies may create opportunities for skilled active managers.
- There are often companies listed on both the domestic exchanges and Hong Kong's exchange.
 - Allows active managers the ability to move between A-share and H-share equity markets as a potential source of value.
 - Valuations between markets vary over time, but often companies that have dual listings have traded at higher prices on the domestic exchanges.

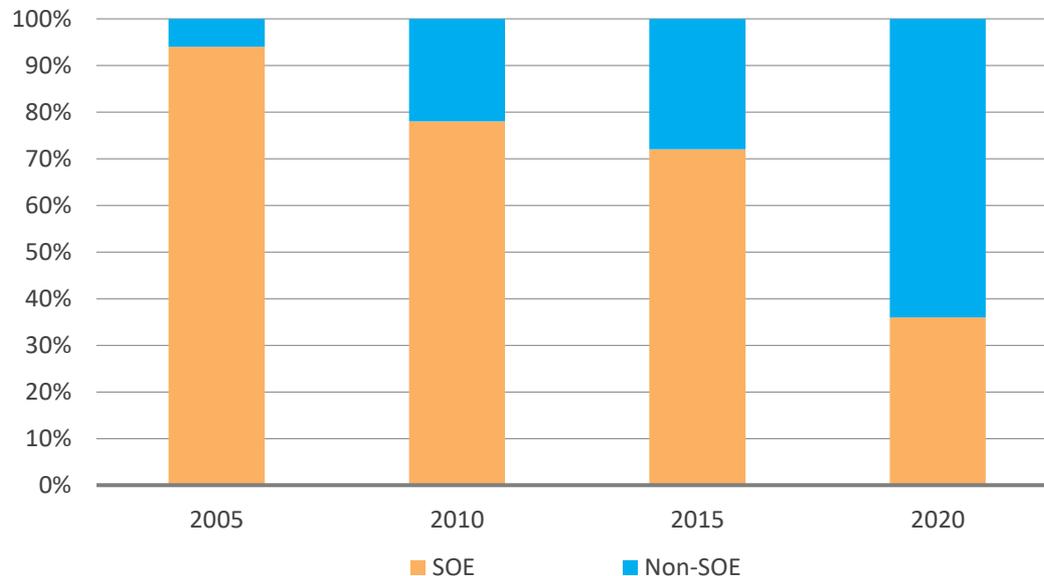
Average A-H Premium on Domestic Exchanges



GOVERNMENT EQUITY OWNERSHIP

- Retail investors account for the vast majority of trading, but not ownership in A-shares.
- A-shares have been predominately owned by the Chinese government and individuals associated with the Chinese government, but they are infrequent traders.
- Increasing the privatization of business is a significant initiative in China and has already led to a decline in the number of state-owned enterprises.

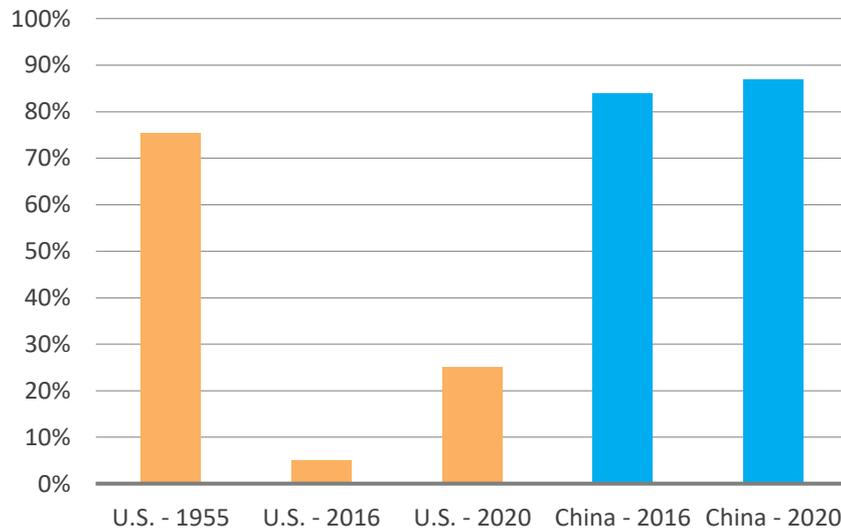
Composition of SOE and Non-SOE Companies in MSCI China (%)



RETAIL INVESTORS

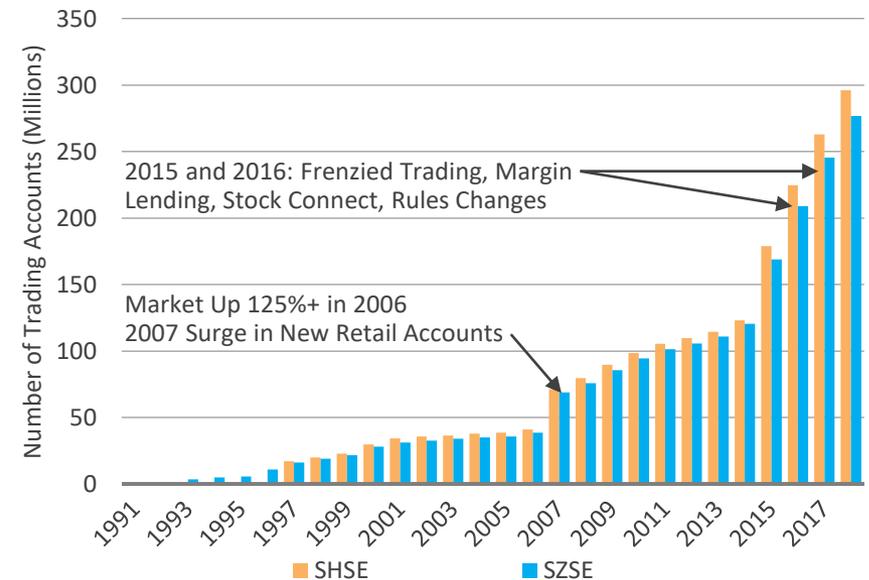
- Chinese retail investors provide considerable liquidity to the market; but have been characterized as having a more speculative view of equity investing.
- As institutional investment grows, a catalyst for decreased volatility similar to other markets where institutional investors comprise the majority of investors could emerge.

Trading by Retail Investors: U.S. vs. China



Data Source: Rayliant, as of September 30, 2020

Number of Stock Trading Accounts for the Shanghai and Shenzhen Exchanges



Data Source: Rayliant, as of September 30, 2018

RISKS AND ANOMALIES

RISKS

The universe of companies trading on domestic Chinese exchanges is vast, but...

- China is an authoritarian government; and the government has shown an interest and willingness to exert some level of control over equity markets.
- Macro and geopolitical risks remain and range from trade disputes, capital controls, and the relationships with nations like North Korea and Russia that differ from the U.S. relations with those nations.
- Uncertainty remains around the outcome of state-owned enterprise reform.
- Historically, China has not been known for a preponderance of high-quality companies and strong corporate governance, and eagerness to attract foreign capital could lead to mismanagement.
- Many companies have short operating histories.
- Frequently changing regulations can be hard to navigate.

TRADING SUSPENSIONS LESS OF A PROBLEM?

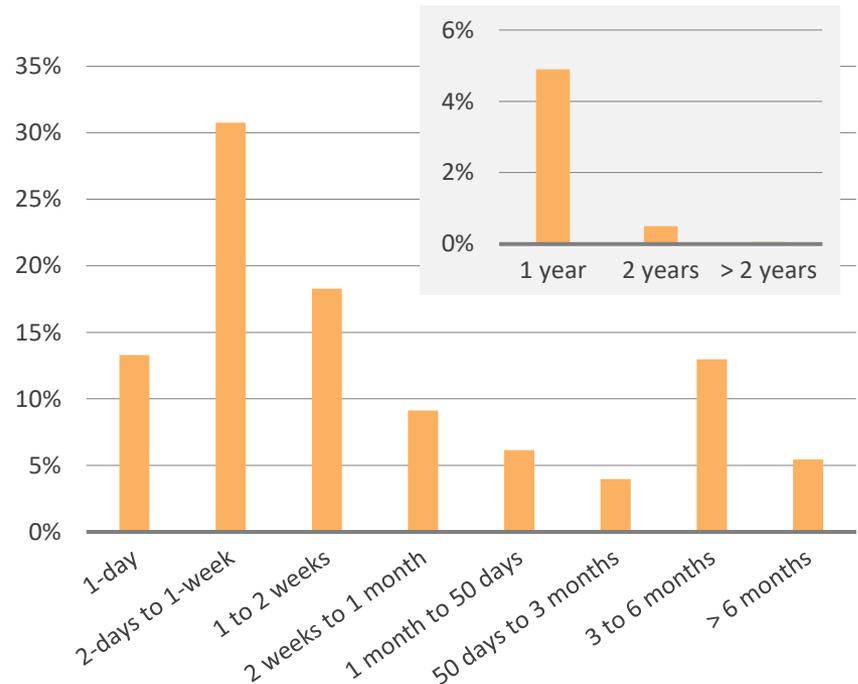
- Suspensions of stocks trading on exchanges has been more frequent among China A-shares than other global equity markets.
- Chinese authorities have moved to reduce trading suspensions as part of the improvement sought by MSCI before inclusion of A-shares in MSCI indices.
- While progress appears to be taking root, suspensions present a risk to market liquidity.

Timeline of China A-Shares Suspensions



Data Source: Acadian as of September 30, 2020

Average Duration of an A-Share Suspension



Data Source: Acadian as of September 30, 2020

SUMMARY

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- China A shares have been added to various indices. Initially, the inclusion is small, but ultimately could be significant.
- Investors should expect to see more active and passive emerging markets managers adding exposure to China, as well as more dedicated China funds and A-shares funds.
- The A-shares market has characteristics of a less efficient market, which presents opportunities for active equity managers.
- Over the long term, some investors may have dedicated China allocations similar to dedicated U.S. or European allocations.
- China is a large and liquid market, but retains many of the risks that are present in smaller, less liquid equity markets.

APPENDIX

APPENDIX

The impact of China A-shares inclusion in indices is significant, but this is not the only noteworthy change.

- Saudi Arabia's inclusion in emerging markets was announced in 2019 by MSCI and FTSE Russell.
- Reclassification of Argentina to emerging market by MSCI in 2019 (impact on MSCI indices below).
- Prior changes that had significant impacts on indices:
 - Pakistan reclassified as emerging market by MSCI in 2017.
 - Qatar reclassified as emerging market by MSCI in 2014 and FTSE Russell in 2016 and 2017.
 - United Arab Emirates reclassified as emerging market from frontier market by MSCI in 2014.

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- All data as of June 30, 2018 unless otherwise noted.
- For more information on indices and definitions please contact information@feg.com



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