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In Focus

Investment Insights into Current Events

China's Regulatory Shifts Impacting Emerging Markets

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Key Observations

- *Chinese equities delivered significant negative returns in 2021 while other emerging and developed markets returns have been positive.*
- *This underperformance has been sparked by the Chinese government's implementation of new regulations across multiple industries with the stated goal of common prosperity and greater social equity.*
- *Investors sold Chinese equities indiscriminately due to the uncertainty surrounding the changing regulatory environment and its impact on company fundamentals.*
- *Fiducient Advisors' view on the asset class remains unchanged; emerging market equities, including China, are inherently the riskiest liquid allocation in client portfolios, but remain an attractive source of returns over the long-term given the higher growth potential of these economies.*

Performance Year-to-Date

Chinese equities endured a difficult 2021 with the MSCI China Index returning -12.3 percent year-to-date through August, among the worst performing countries within the MSCI Emerging Markets Index. Meanwhile, the MSCI EM ex-China Index has returned +12.7 percent and developed markets have also had strong years with the Russell 1000 and MSCI EAFE Index returning +20.4 percent and 11.6 percent respectively.

Chinese equities had a strong start to the year after a solid 2020 due to the country's success containing the pandemic. However, that outperformance reversed in February with the bulk of the Chinese market's underperformance coming in March (-6.3 percent) when the Chinese government ended its pandemic-related stimulus and tempered expectations for economic growth, and in July (-13.8 percent) when the Chinese government announced the implementation of several new regulations for various industries that seemingly took investors by surprise.

Regulatory Catalysts

2021 saw a rapid acceleration of regulatory interventions by the Chinese government. While the impact on technology stocks has been the primary focus of investors, regulatory changes have, in fact, been implemented across multiple industries, including internet, education, food delivery and real estate. It is believed the goal of this policy is to support the Chinese Communist Party's (CCP) social initiatives to achieve common prosperity and greater social equity. In summary, these regulations include[1]:

- Fintech regulations, which impacted the IPO of Alibaba's Ant Group late last year
- Anti-monopoly regulations, which had particular focus on the dominant internet platforms
- Private sector education, which was arguably the most onerous as K-12 after school tutoring was effectively banned, and the companies were forced to become nonprofit organizations
- Content restrictions, which affected entertainment and social media platforms
- Data security regulation

Following what transpired in July, there appears to be a shift in Beijing's approach. Prior, it was believed that companies, which ran afoul of various regulations, would receive a slap on the wrist consisting of a monetary fine and additional restrictive regulatory measures. For example, following the government's anti-monopoly investigation of Alibaba last year, the company received a fine of $2.8 billion, the largest ever handed out by Chinese regulators. However, that amount was only 4 percent of Alibaba's total sales in 2019[2]. Investors felt that the Chinese government would rein in the most egregious violators, but its ultimate goal was to foster Chinese dominance in industries deemed vital for national security, particularly technology.

That said, the Chinese government may have now changed course by implementing prohibitive policies on certain sectors. It appears government officials are not afraid to stifle a company's business or even crush entire industries (like for profit education) if they believe there are issues that are not serving the greater good of the country. For this recent crackdown against companies including Didi, Tencent, New Oriental and TAL Education, Beijing is pointing to financial risk, antitrust concerns and national security violations. The CCP seems to be accepting of stockholder pain for long-term social control.

These regulatory maneuvers surprised many investors, sparking the severe selloff in Chinese equities in July and forcing a reevaluation of the risks of investing in Chinese stocks. In addition, the investment thesis for each company needs to be reassessed to incorporate these higher regulatory risks as well as changes to the fundamentals of each business as they comply with the government's wishes. For example, Tencent and

[1] Invesco
[2] FactSet

NetEase recently announced a three-hour limit per week for children to play the companies' games[3]. Further, Tencent, Alibaba, Pinduoduo, Xiaomi and Meituan announced they will donate billions of dollars' worth of cash or company stock to Chinese social programs; it is unknown whether this is a one-time or recurring event. These developments have understandably sparked fear and uncertainty in markets, spurring investors to question how much further these regulatory efforts will go, and which industries and companies could be impacted next. That said, there have been some positive developments in recent weeks to suggest the Chinese government does not plan, nor does it want to, completely suppress foreign investment in the country; these include[4]:

- Hong Kong Exchanges and Clearing announced that an A-share futures contract will be launched in October. This is expected to improve the accessibility of the A-share market to overseas investors and is likely to accelerate an increased weighting of A-shares in global indices.
- Informed sources disclosed to the press that the China Securities Regulatory Commission (CSRC) is formulating a plan to break the impasse with U.S. regulators on the accounting and disclosure standards of Chinese companies with U.S.-listed China ADRs, thus heading off the risk of compulsory delisting.
- There have also been press reports highlighting the concerted effort being made by Chinese regulators to resolve the issue about data security, which was at the heart of Didi's less than successful recent debut in New York.

Fiducient Advisors' View

Changes in policy often feel extreme because they can happen quickly and often without warning, but political risk within emerging markets, and particularly China, is not new. However, this recent regime shift from Chinese regulators serves as a reminder that the potential for outsized returns does not come without risk, and bouts of higher volatility will occur at times within emerging markets. For example, the average drawdown for the MSCI China Index has averaged 28 percent over the past 20 years since China entered the World Trade Organization in 2001[5]. Nonetheless, the asset class remains an attractive source for returns and diversification over the long-term given the growth potential of these economies.

Foreign investors had seemingly been lulled into believing China's economy was capitalist based, but after these events, they will watch intently for signs of whether President Xi Jinping plans to further extend the CCP's reach into the economy. It is difficult to predict the impact of additional regulations on individual securities or industries, but these circumstances, among others, stand as added rationale for why we believe both an active and balanced style approach with allocations to value and growth benefits investors. Utilizing active managers, who can assess and weigh regulatory risks against the potential rewards of future growth

[3] CNBC
[4] Aubrey Capital
[5] "Is China's Bear Market an Opportunity", Charles Schwab, August 2, 2021

into their investment decisions, can help mitigate some of the volatility of investing in the emerging markets asset class.

For more information, please reach out to any of the professionals at Fiducient Advisors.

About the Author

As a member of the Global Public Markets Team, Oakley conducts investment due diligence on non-U.S. growth managers. Oakley joined Fiduciary Investment Advisors LLC in 2014, which combined with Fiducient Advisors in 2020. Prior to joining the firm, he was an Associate with Stripes Group in New York where he worked as the lone analyst to the CIO of the firm's award-winning fund of hedge funds. Oakley attended Georgetown University where he received both his MBA and BA. Additionally, he is a Chartered Alternative Investment Analyst (CAIA℠). Oakley is a member of the North Shore Land Alliance Heritage Committee and the Junior Committee for the Glen Cove Boys and Girls Club. He enjoys golf, squash, travel and promoting environmental conservation.

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