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A CONVEX EXPOSURE TO CHINA'S A-SHARE MARKET OPPORTUNITIES

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UBP

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Asset Management | Marketing communication

Key points

- *China is the second-largest economy and the second-largest equity market in the world. For investors, it is undeniable that it remains at the heart of global growth, but global indices often fail to account for this, hence the choice of standalone allocations to mainland China.*
- *The Chinese onshore convertible bond market has soared drastically since early 2017 due to regulatory changes fostering more transparent financing. Today it is the second-largest market in the world and is worth around USD 131 billion with approximately 460 issuers.*
- *There is no overlap between the onshore markets, H-shares, and ADR convertibles; this situation offers a complementary opportunity.*
- *The onshore market is dominated by mid- and large-cap names at an earlier stage of the growth cycle which are benefitting from domestic growth, and it does not include real-estate, online education and internet tech names.*
- *More importantly, what makes the onshore market so appealing is not its size but the set of unconventional features that it provides. Local convertible bonds are all issued with a set of investor-friendly clauses available only in China.*
- *These clauses have a positive impact on the downside capture of convertible bonds, which has reached 30% since the end of 2016, while the upside capture has been maintained at 49%.*
- *The convex nature of convertibles has provided investors with long-term benefits, such as equity-like returns with reduced volatility and drawdowns. Therefore, Chinese onshore convertible bonds represent an attractive way to build exposure to China's A-share market.*

China has grown far more quickly than other major economies over the past 20 years and although its growth rate is slowing it is expected to continue to be one of the driving forces of global economic growth. China's GDP stood at USD 17,745 billion in 2021, making it the second largest in the world, and the penetration of the Chinese economy within international trade is undeniable, representing 15% of global exports and 12% of global imports. Overall, China accounts for around 20% of global GDP. While already being close to two-thirds of US GDP, it is expected that Chinese GDP could equal that of the US by 2030.

Behind this economic performance are long-term drivers: the urbanisation ratio in China has increased rapidly, and a real middle class – eager to reach western standards in terms of quality of life – has been emerging.

Mirroring the phenomenal growth of its economy, Chinese capital markets have also become the world's second largest for both equities and bonds. However, this huge economic potential is clearly not yet reflected in global indices. As at 30 December 2022, the MSCI AC World Index had a 60% exposure to the United States but only a 3.6% allocation to China. Based on the size of its economy and domestic market capitalisation, we would expect China to account for at least 10% of global indices. Consequently, for global investors to gain a broad exposure to China's domestic opportunities, they have to consider mainland China as a building block in and of itself.

Chinese onshore Convertible bonds offer access to A-shares with lower volatility

Global investors still mostly favour onshore equities, i.e. the A-share market (the CSI 800 Index), to build exposure to the Chinese economy; however, the **high volatility associated with these shares has historically been a drawback**. If we look back at the behaviour of onshore equities since the end of 2016, they exhibited an annualised volatility of 19% with three drawdowns exceeding 30%. We believe Chinese onshore convertible bonds (represented by the CSI Convertible Bond Index) counterbalance this by offering a low-volume exposure to the A-share market. Over the period under analysis, **Chinese onshore convertibles have not only outperformed onshore equities in absolute terms with an annualised return of 5.6% vs. 3.3%, respectively, but have also exhibited better risk-adjusted returns. The annualised volatility of onshore convertible bonds was almost half that of equities at 10%** and the maximum drawdown was almost a third of that of equities (Figure 2).

Figure 1: Less volatile equity-like performance

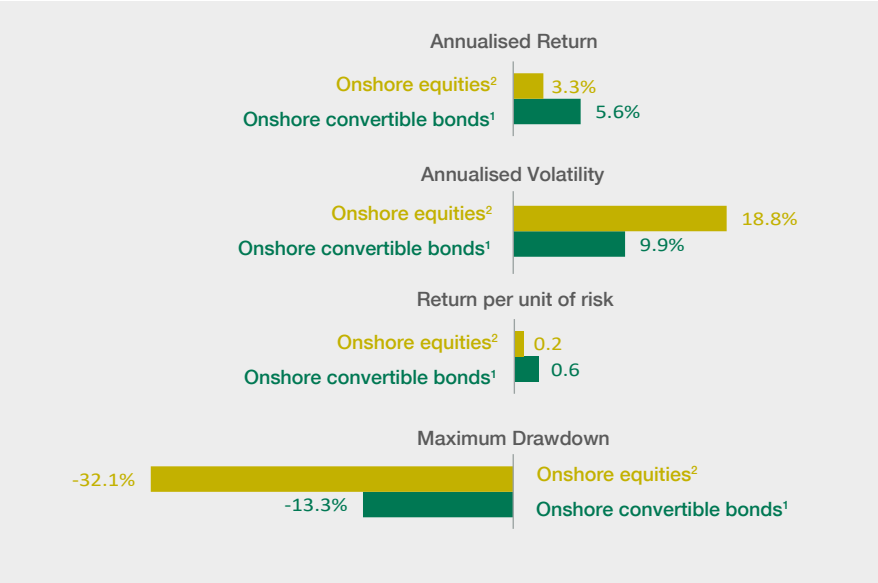
Total Return Performance - Rebased at 100

Sources: UBP, Bloomberg Finance LP as at 30 December 2022.
Past performance is not a guide to current or future results.

The difference in volatilities can be explained in part by the market participants. When it comes to onshore equities, Chinese retail investors represent almost half of domestic investors, while convertible bonds are dominated by institutional investors. However, the difference in sector composition has been important in recent years, as onshore convertible bonds have not been exposed to companies targeted by the continued regulatory crackdown observed in China, such as property developers, the gaming industry, for-profit education providers and internet platform names. This has definitely helped onshore convertible bonds' performance since 2020.

Chinese onshore convertible bonds provide investors with what would be expected from the asset class: equity-like returns with lower volatility. For investors, this is an opportunity to have a more efficient solution to build their exposure to mainland China's domestic economic growth.

Figure 2: The competitive edge of convertible bonds

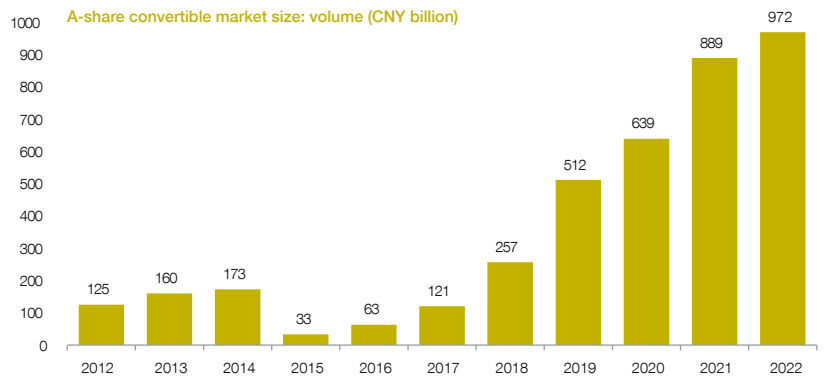


Sources: UBP, Bloomberg Finance LP.
[1]CSI Convertible Bond Index (CNY)
[2]CSI 800 Net TR Index (CNY) using daily data from 31 December 2016 to 30 December 2022.
Past performance is not a guide to current or future results.

A young but already very large asset class

Although China's first onshore convertible bond was issued in November 1992, the market did not take off until relatively recently. We can trace back the meaningful increase in issuance volume to the Chinese regulator's moves to crack down on illicit banking activities known as "shadow banking". After the global financial crisis of 2007–2008, shadow banking activities started to blossom on the back of China's huge stimulus plan, with companies raising debt through a more loosely regulated system of credit intermediation. The dangerous growth of these activities led the China Banking and Insurance Regulatory Commission (CBIRC) to issue new directives in 2017, with the objective of modernising its capital markets and reducing unregulated off-balance-sheet financing. As a result, a large number of companies, especially small- and mid-cap companies at an earlier stage of growth, needed to find new ways of raising capital in order to support their economic development. Convertible bonds became a convenient instrument to raise debt, as they are more cost-efficient for companies compared with loans thanks to relatively lower coupons. They are also a way to diversify their sources of capital, as convertible bond buyers are mainly institutional investors. Consequently, the convertible market has grown at a tremendous pace, **from 24 issuers and a total market cap of CNY 63 billion (USD 9 billion) at the end of 2016 to 460 issuers and a total market cap of around CNY 972 billion (USD 131 billion) at the end of December 2022** (Figure 3).

Figure 3: A flourishing market



Source: Wind, UBP as at 30 December 2022.

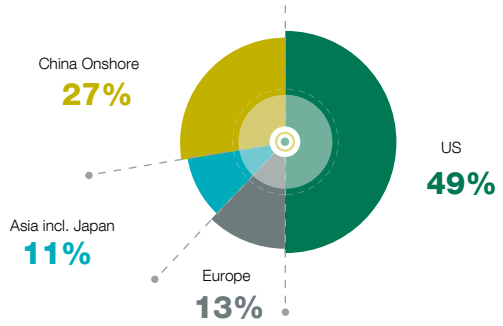
This positioned the **Chinese onshore convertible bond market as the world's second largest behind the United States**; it is currently **twice as big as the entire European market and three times as big as the rest of Asia (including Japan)** (Figure 4).

Therefore, Chinese onshore convertible bonds should not be considered as niche and the market's size definitely warrants a closer look.

We do not see any signs of a slowdown in the Chinese primary market and 2022 has been another strong year, with 122 new issues, representing more than USD 27 billion as at the end of December 2022.

Figure 4: The only market competing with the US

Global Convertible Bond Market - Regional Breakdown



Sources: Wind, Bank of America Merrill Lynch, UBP as at 30 December 2022.

A diverse and complementary investment bucket

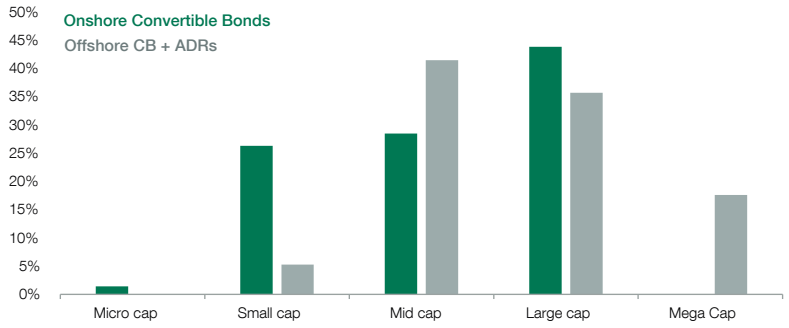
Onshore Chinese convertible bonds prevail as a complementary opportunity set because there is **no overlap with Chinese companies in H-shares or ADRs**. In this sense, onshore convertible bonds provide a pure exposure to the A-share market and, consequently, access to the Chinese domestic growth drivers and opportunities.

In addition, the composition of the onshore convertible universe offers diversification from market-cap and sector perspectives. The **Chinese onshore convertible market is made up of smaller companies at an earlier stage of their growth cycle**: close to 30% of the underlying companies have a market cap below USD 2 billion. The onshore convertible bond universe also has no exposure to mega caps (see Figure 4). Overall, the onshore convertible space has a weighted average market cap of USD 12 billion, which is almost half the weighted average market cap for H-shares combined with ADR convertibles, which is equivalent to USD 31 billion.

As previously noted, **onshore convertible bonds' underlying companies were not exposed to the latest regulatory crackdown, especially as there were no property developers involved**. Overall, onshore convertibles are far less exposed to the consumer discretionary and communications sectors when compared with Chinese H-shares' and ADRs' convertibles. However, when

Figure 5: Diversified with a small-cap tilt

Market Cap Breakdown

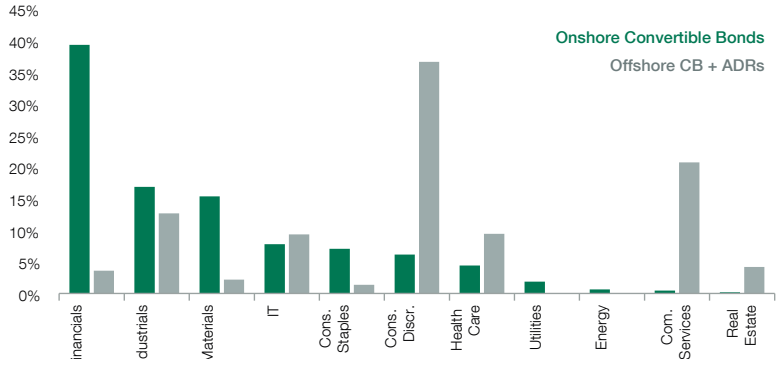


Sources: Wind, Refinitiv, Bloomberg Finance LP, UBP as at 30 December 2022.

"A - CB" = all outstanding onshore Chinese convertible bonds weighted by their outstanding volume. "H-CB + ADR" = securities from the Refinitiv Global Convertible Bond Index whose underlyings are domiciled in China (weightings rebased at 100%).

Figure 6: From a market-cap perspective onshore convertible bonds have a bias towards financials

Sector Breakdown



Sources: Wind, Refinitiv, Bloomberg Finance LP, UBP as at 30 December 2022.

"A - CB" = all outstanding onshore Chinese convertible bonds weighted by their outstanding volumes. "H-CB + ADR" = securities from the Refinitiv Global Convertible Bond Index whose underlyings are domiciled in China (weightings rebased at 100%).

looking at the sector breakdown of the onshore convertible market using market weightings, what stands out is the significant overweight in financials, and banks in particular (Figure 6). This peculiarity of the market is a bias that needs to be addressed when building a portfolio and this is what we do in our Chinese convertible strategy in order to maintain a well-diversified exposure to the domestic Chinese economy.

Highly attractive features

Chinese onshore convertibles have specific features that not only set them apart from those in the rest of the world but that also are very appealing to investors. These unique clauses, detailed in Table 1, create a very particular cash-flow profile (Figure 7) for Chinese convertibles.

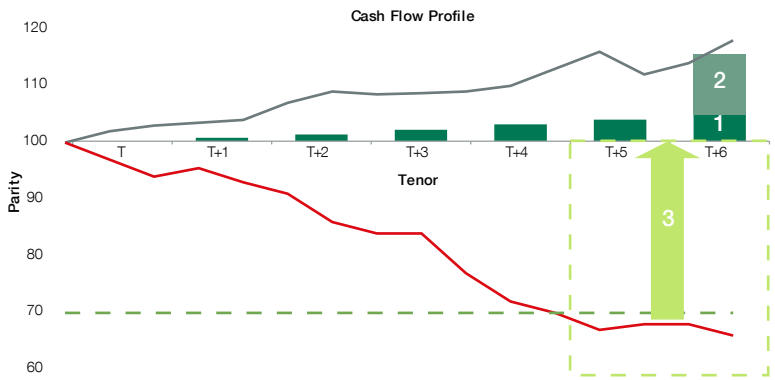
Table 1: Unique investor-friendly clauses

Clauses	Percentage of convertible bonds
1. **Stepping-up coupon scheme**: ranges can be quite large, increasing from 0.1%–0.6% in year 1, to 1.8%–5% in year 6.	100%
2. **Interest compensation**: if a convertible bond reaches its maturity date because it has not been converted, is out of the money and not redeemed early, Chinese onshore convertible bonds offer a compensation mechanism in the form of an additional final coupon ranging between 5% and 15%, and with an average of 9%	100%
3. **Puttable clause**: within a preset, defined period (usually the final two years of convertible bond's life), a put option is activated if the underlying stock price trades below a predefined level (typically parity <70) for over 30 consecutive business days. Once this put option is available to the investor, they can ask for early redemption at par value.	94%

These clauses are structural and are key to strengthening the bond floor which, in turn, massively improves the downside resilience of the asset class Indeed, theses clauses are protection mechanisms as, whether it is the interest compensation or the puttable clause, they both offer the opportunity to partially offset the risk of an adverse evolution of the issuer's stock price that would lead to non-conversion of the bond. Therefore, they have a positive impact on the equity's downside capture ratio.

Another difference is that Chinese onshore convertible bonds are all rated and traded on an exchange, while global convertible bonds are traded over the counter. This offers full transparency in terms of market liquidity, trading volumes and prices.

Figure 7: Illustration of the cash-flow profile of a Chinese onshore convertible bond



For illustrative purposes only.

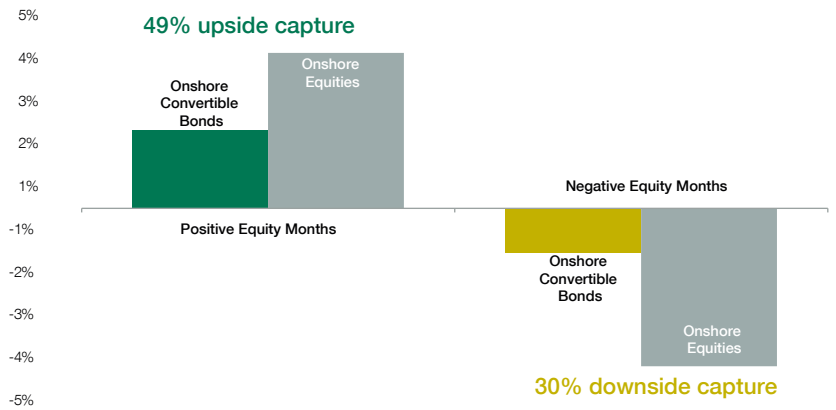
Delivering outstanding convexity

When considering convertible bonds, investors look for convexity, namely an asymmetric risk/return profile, that enables them to capture more of equity markets' upside than downside. We have highlighted the strong risk-adjusted return delivered by the asset class since the beginning of 2017 in Figure 2, but we have not yet talked about convexity.

The specificities previously described underpin the strongly convex profile of Chinese onshore convertible bonds. **Since the meaningful surge in the market at the end of 2016, the CSI Convertible Bond Index has posted a 49% upside capture and only a 30% downside capture vs. the CSI 800 Index** (Figure 8). Market figures show these are the most attractive convex characteristics across all regions worldwide over that period.

Over the last two years, China has been facing several headwinds, from continuing Covid-19 issues to regulatory crackdowns and concerns regarding the country's real-estate sector. More recently we have seen power shortages having an impact on economic activity. The Chinese economy has been buffeted by these headwinds and the associated disruption to logistics and supply chains. This, combined with China's position on the Russian war in Ukraine, has fuelled negative sentiment towards Chinese assets. For all of these reasons, onshore equities have experienced high volatility and performances have been particularly weak. It actually proved to be a good test to highlight the benefits of convertibles when it comes to mitigating downside risks and limiting drawdowns.

Figure 8: Outstanding convexity characteristics



Sources: UBP, Bloomberg Finance LP as at 30 December 2022.
China onshore convertible bonds measured using the CSI Convertible Bond Index (CNY).
Equities are measured using the CSI 800 Net TR Index (CNY).
Past performance is not a guide to current or future results.

CONCLUSION

Being the second-largest economy in the world, it cannot be denied that China is now one of the major driving forces of global growth. However, despite a significant rise over the last decade to become the second-largest capital market globally, Chinese onshore financial assets are often overlooked. This is the case for convertible bonds in particular, although the market has grown significantly over the last six years to become the second largest behind the US. We believe that, among various potential reasons, the high volatility shown by the Chinese onshore equity market has been a disadvantage and has created a certain amount of resistance among global investors when considering a standalone allocation to mainland China. In our view, this is where convertible bonds have a role to play in global asset allocations: they offer equity-like returns with lower volatility and contained drawdowns. Furthermore, they are a pure allocation to onshore China as there are no overlaps with H-shares or convertible ADRs. Chinese onshore convertible bonds are mainly issued by small- and mid-cap companies at an earlier stage of growth across various sectors, allowing a diversified and balanced exposure to the domestic Chinese growth.

In addition, Chinese onshore convertibles have distinctive specificities when compared with global convertibles. First and foremost, they have unique, investor-friendly clauses which structurally strengthen their bond floors and improve the behaviour of the asset class during downside equity movements. Second, they are all rated and traded on exchanges whereas global convertibles are traded over the counter.

Overall, thanks to their unique qualities, Chinese onshore convertibles have exhibited outstanding convexity characteristics and attractive risk-adjusted performances. However, given the specificities of Chinese onshore convertible bonds, we believe it is essential to have local expertise to access this market. For investors, Chinese onshore convertible bonds constitute an attractive way to build exposure to the Chinese A-share market while also containing its volatility.

Matthieu Tournaire

Senior Investment Specialist – Convertible Bonds

Union Bancaire Privée, UBP SA | Head Office
Rue du Rhône 96-98 | P.O. Box 1320 | 1211 Geneva 1 | Switzerland
ubp@ubp.com | www.ubp.com